SAUDI ARABIA AS A “SWING OIL PRODUCER”

IN THE FIRST HALF OF THE 1980s

by

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ABSTRACT

The dissertation examines Saudi oil policy, focusing mainly on the first half of the 1980s. In this period, Saudi Arabia played a “swing producer” role to control oil prices in the world oil market. This behavior of Saudi decision-makers can be understood within the economic framework of the “dominant producer” model. After interdisciplinary research on previous political and economic studies of Saudi oil policy, the dissertation concludes that the basic notion of Saudi oil policy as a “swing producer” was intended to meet Saudi Arabia’s long-term political and economic interests. It was therefore logical for Saudi officials to implement the oil policy of “swing producer” to maximize the long-term economic value of Saudi oil, since this would also contribute to the political consolidation of the Saudi regime. However, there are several questions still remaining in the details of this oil policy. In contrast to the argument of the “dominant producer” model, why did Saudi Arabia try to achieve relatively high oil prices at the expense of its already reduced market share during this period? If Saudi oil policy as a “swing producer” was derived primarily from the state’s long-term economic interests, why did it suddenly give up this role in the summer of 1985? To answer these questions, it was necessary to examine Saudi oil policy since December 1976, because it was at this point that the state began to implement an oil policy based on its national interests. After a comprehensive study on Saudi oil policy during boom and slump periods, I have identified the main priorities of Saudi oil policy in these two different periods, and have

tried to draw a conclusion that provides the readers with plausible answers to the main questions in my dissertation.

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CHAPTER I

INTRODUCTION

Whether intentionally or not, the Arab oil embargo in 1973-74 turned Saudi Arabia into a key actor in Arab politics. During the previous oil embargoes in 1956 and 1967 Saudi Arabia had been relatively isolated from Middle Eastern politics and its apparent indifference to the Arab-Israeli conflict was the subject of constant criticism on the part of the revolutionary states in the Middle East because of the increasing popularity of Nasserism and pan-Arab nationalism. However, after the Arab defeat in the war against Israel in June 1967, the revolutionary governments in the region—particularly Egypt, led by Nasser, who symbolized the illusion of pan-Arab nationalism—lost much of their clout in Middle Eastern politics. Furthermore, the oil embargo and the oil price increases after the Arab-Israeli war in October 1973 gave Saudi Arabia an opportunity to emerge as a financial power not just in the Middle East but in the world as a whole. With its considerably increased financial surplus, it began to expand its financial support both for its poorer Arab neighbors and other Muslim countries through various forms of aid. On the other hand, the West, particularly the United States, began to regard Saudi Arabia as a major country for petrodollar recycling in various ways, particularly sales of goods and arms, participation in huge development projects, and foreign investment. More importantly, because of its huge oil reserves and considerable production capacity, Saudi

Arabia came to play a vital part in Arab politics, when the Arabs tried to use oil as a political weapon against the West or Israel. No other Arab oil producing country could deal such a blow to the Western economy through its decisions on output as Saudi Arabia. The realization that oil could be used as an effective political weapon for the Arabs moved Saudi Arabia from the fringe to the center of Arab politics. With the growing expectations of neighboring Arab countries for an increasing role for Saudi Arabia in Arab politics after the Arab oil embargo, it could no longer ignore major political issues in the Middle East.

To understand how Saudi Arabia emerged as a key political actor in the region, we should look into the structural changes in the world oil market and the development of the Saudi oil industry since the late 1960s. In addition to the US' increasing dependence on foreign oil, particularly on oil produced by OPEC (the Organization of Petroleum Exporting Countries), the diminishing power of the major international oil companies since the late 1960s accelerated the emergence of a new price regime controlled by OPEC. With the increasing role of OPEC in the world oil market in the 1970s, Saudi Arabia began to attract the attention both of consuming and producing countries because of its considerably increased production capacity and huge oil reserves, which could affect oil prices. Furthermore, the successful nationalization process of the Arabian American Oil Company (Aramco) during the 1970s allowed Saudi Arabia to implement its own oil policy, and the world oil market was now obliged to pay attention to the decisions of Saudi policy makers. After all, the oil embargo in 1973-74, in which Saudi Arabia joined, not only brought decisive changes to the relations between oil producing and consuming countries, but also gave Saudi Arabia higher status within OPEC and the

Organization of Arab Petroleum Exporting Countries (OAPEC) as the most influential oil exporting country in the world.

As early as the late 1960s, there had been signs of change in the relationships between the oil producing countries, represented by OPEC, and the oil consuming countries in the world oil market. These included such events as the Libyan revolution of 1969 and the emergence of the US as the main world importer of oil. As the rapidly increasing rate of US consumption began to overwhelm the sluggish growth of oil production and reserves during the 1960s, the US could no longer act on its own to stabilize the world oil market. In addition, the state-owned oil companies in Europe such as Elf and Total of France and AGIP of Italy, were becoming more involved in the oil-producing countries of the Middle East, attacking the monopoly buying practices of the major multinational companies, represented by the so-called "Seven Sisters:" BP (British Petroleum), Exxon, Gulf, Mobil, Shell, SOCAL and Texaco.[1] In addition to the increasing dependence of the US on foreign oil, the birth of many smaller independent oil companies contributed to the reduction of the market power of the Seven Sisters, allowing OPEC to take over some of the decision-making on setting oil prices.

Most Middle Eastern oil-producing countries, including Saudi Arabia, gradually took the opportunity presented by the changing environment in the world oil market to nationalize their oil. Saudi Arabia's plan to take over 100% ownership of Aramco, which produced most of Saudi oil, was well under way in the 1970s. Unlike other oil-producing countries in the Middle East that had acquired increasing control over "their" oil from Western operating companies, other oil companies, especially Exxon and Mobil, had

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[1] Rodney Wilson et al., *Economic Development in Saudi Arabia* (London and New York: RoutledgeCurzon, 2004), 42.

continued to enjoy traditional ownership and management roles in Saudi Arabia before 1973. However, under circumstances that increasingly favored the nationalization of the oil industry in oil-producing countries, especially in the 1970s, the Saudi government entered into negotiations with the American owners of Aramco.[2] In 1973, it took a 25% stake in Aramco and increased this to 60% in 1974, giving the state a majority share. Arrangements for retaining the total ownership of Aramco were reached in 1976 and payments to the four Aramco parent companies were completed in 1980. By 1988, Aramco had become a totally Saudi owned company called Saudi Arabian Oil Company (Saudi Aramco).[3]

Substantial investment in the Saudi oil industry in the late 1960s had contributed to the increasing oil production and reserves in the 1970s. Saudi Arabia had, therefore, enhanced its long-term ability to generate oil revenues with its increased production capacity and huge oil reserves.[4] Proven oil reserves had increased dramatically from 66,000 million barrels in 1966 to 163,350 million barrels in 1979, rising from 17% to 25.8% of total world proven oil reserves.[5] Production had risen steadily during the 1970s, from 3.8 million barrels per day (b/d) in 1970 to 7.6 million b/d in 1973, 8.5 million b/d

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[2] Ibid., 42-43.

[3] Helen Chapin Metz, ed. *Saudi Arabia: A Country Study* (Washington, D.C.: Federal Research Division, 1992), 139.

[4] Tim Niblock and Monica Malik, *The Political Economy of Saudi Arabia* (New York: Routledge, 2007), 52.

[5] See Table 1-2 and 1-4 in F. R. Parra Associates, "The International Oil Industry 1950-1992: A Statistical History," (Reading, UK: F. R. Parra Associates, 1993).

in 1975 and 9.5 million b/d barrels in 1979.[6] At the end of the 1970s, Saudi production already accounted for almost 15% of world oil, and for over one-third of OPEC oil. When OPEC was established in 1960, Saudi Arabian oil production accounted for only 15% of total OPEC oil production.[7] In comparison with Saudi Arabia's relatively small contribution not only to OPEC but also to the world oil market in the early stage of OPEC, there is no doubt that its strategic importance within OPEC increased dramatically with the growth of production and the increase in proven oil reserves. Furthermore, as Saudi Arabia's output decisions became a major factor in influencing oil prices, it was gradually exposed to increasing pressures from its Arab neighbors to use its oil as a political weapon.

With the emergence of a new price regime dominated by OPEC in the 1970s, the monolithic cartel model became popular to explain the new structure of the world oil market. Many economists created an academic discourse around the anticipated collapse of OPEC as a part of classical cartel theory and the strategy of consuming countries to encourage cheating among OPEC members such as the introduction of import tickets presented by Morris Adelman.[8] However, in spite of Adelman's predictions, OPEC survived without any serious cheating among its members in the 1970s and even into the early 1980s. To understand how OPEC managed to succeed as a cartel without widespread cheating among its members and without precipitating the collapse of the

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[6] OPEC, "OPEC Annual Statistical Bulletin 2002," (Vienna: OPEC, 2002).

[7] British Petroleum, "BP Statistical Review of World Energy June 2010," (British Petroleum, 2010); OPEC, "OPEC Annual Statistical Bulletin 2002," 42-53.

[8] Morris A. Adelman, "Oil Import Quota Auctions," *Challenge* 18, no. 6 (January-February, 1976): 17-22.

organization, economists such as Morris Adelman, John Blair, Robert Mabro, Theodore Moran and David Teece tried to apply their own theoretical tools to OPEC. However, all these arguments had their own theoretical limitations and could not provide plausible explanations.

In the early 1980s, economists began to pay attention to the role of Saudi Arabia as a "swing producer" in the world oil market, introducing the dominant producer model to explain the structure of the world oil market and its characteristics. In comparison with the situation of the world oil market in the 1970s, the soft market situation in the 1980s revealed that previous explanations of the world oil market, focusing on OPEC as a cartel, were not valid. Although the possibility of the breakdown of OPEC seemed very high with widespread cheating among OPEC members in the first half of the 1980s, no such collapse actually took place. Saudi Arabia had emerged as the leading oil producing and exporting country with a substantially increased market share in the 1970s. In addition, it was the only country to stick to moderate oil prices during the 1970s, unlike most other OPEC members. All this led many economists to highlight Saudi Arabia's role as a swing producer in the world oil market. This academic discourse became popular in explaining the structure of the world oil market and gained persuasive power, particularly in the first half of the 1980s, when the role of Saudi Arabia as a swing producer was evident in the world oil market because of its support of a certain target price level.

As a result, economists tended to apply the role of a dominant producer in the world oil market only to Saudi Arabia. According to this explanation, Saudi Arabia sets the price of oil, while the other OPEC members (including non-OPEC suppliers) sell their oil at whatever level they want. As Saudi Arabia supplies the remaining oil demand, it plays the role of a swing producer to keep a monopoly price by fluctuating its own production level in accordance with the gap between demand and supply in the world oil market. As we can see in Figure 1, during the 1970s and the 1980s Saudi Arabia exhibited behavior typical of a residual supplier within OPEC.

In terms of the emergence of Saudi Arabia as a swing producer, Rachel Bronson regards the year 1972 as an important turning point for the balance of power in the world oil market because the US, which had played the role of "swing producer" in response to the earlier embargos in 1956 and 1967, reached full production capacity for the first

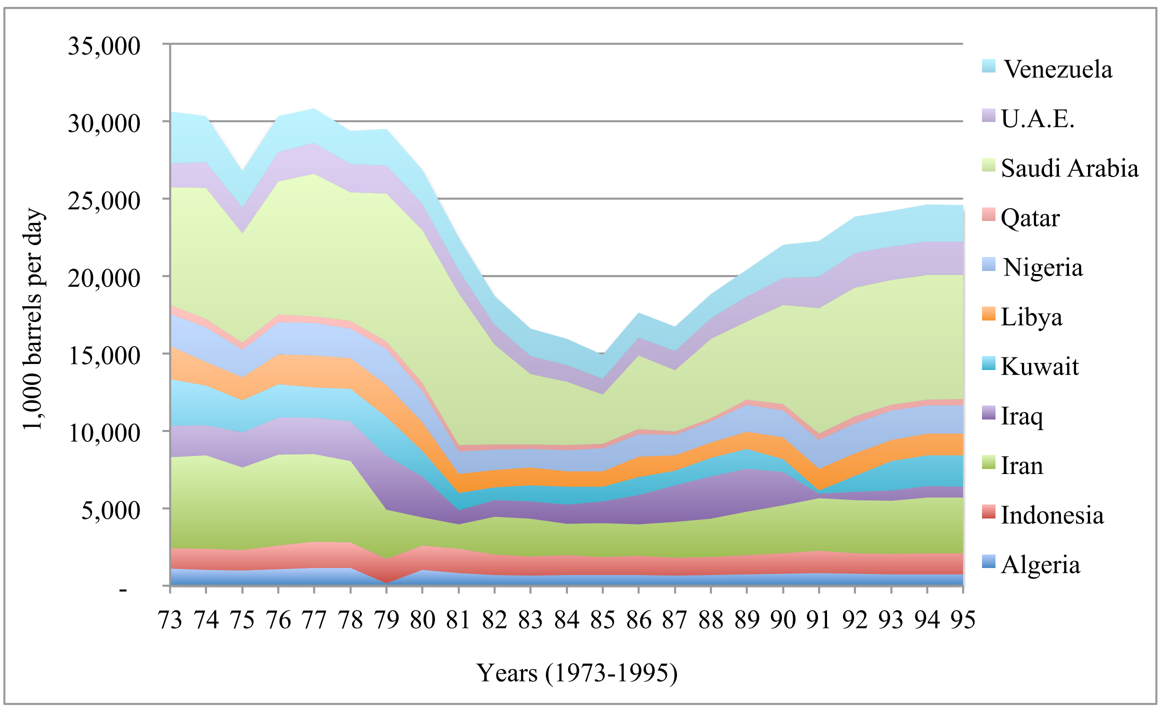

Figure 1. OPEC Production
Data Source: OPEC, "OPEC Annual Statistical Bulletin 2002," 42-53.

time.[9] As a result, it could not compensate for the shortage in 1973 when the Arab oil producing countries agreed to cut their oil production and to embargo the United States and the Netherlands, especially the port of Rotterdam, a principal point of entry and oil distribution center for other European countries. Focusing on the power struggle in the world oil market, Bronson sees 1972, when US production reached its peak, as a crucial moment for the reshaping of the configuration of power in the world oil market. She argues that Saudi Arabia's strategic importance increased as the balance of power for controlling oil prices shifted to the OPEC countries, especially Saudi Arabia itself.

On the other hand, other authors such as Rodney Wilson and Anthony Cordesman regard Saudi Arabia's decision to nationalize Aramco in 1976 as the key event that enabled Saudi Arabia to play the role of swing producer.[10] They focus particularly on its ability to control the production levels of its own oil resources at will through the nationalization of Aramco. Wilson argues that Saudi Arabia's ability to use Saudi Aramco as a swing producer after nationalization enabled the government to make its own strategic decisions on oil production. As the oil industry became modernized and nationalized with increased production capacity, Saudi Arabia could now control its oil output, which varied from as little as 3 million barrels a day to a maximum of around 12 million a day. In contrast to countries such as Iran and Nigeria, which found it hard to cut production, Saudi Arabia and other Gulf OPEC states were more flexible in terms of

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[9] Rachel Bronson, "Understanding US-Saudi Relations," in *Saudi Arabia in the Balance*, ed. Paul Aarts and Gerd Nonneman (New York: New York University Press, 2005), 380.

[10] The Saudi government decided to nationalize Aramco in 1976, but instead of outright expropriation, the king arranged a gradual handover, which was completed in 1980. See Toyin Falola and Ann Genova, *The Politics of the Global Oil Industry: An Introduction* (Westport: Praeger Publishers 2005), 226.

output, because the former had budgetary difficulties, while the latter were in a much more comfortable fiscal situation, at least until the early 1980s.[11] Cordesman also sees the year 1976 as a crucial point for the Saudi Arabian role of "swing producer." He argues that the nationalization in 1976 enabled Saudi Aramco to control most of the country's upstream oil operations. As a result, the kingdom could adjust its level of production by reducing or increasing oil output depending on the market situation. The government's ability to act as a swing producer greatly increased its strategic importance.[12]

Depending on their individual explanations of the emergence of Saudi Arabia as major oil supplying country affecting oil prices in the oil-based world economy—with its strategic decisions on oil output—commentators assess different milestones as marking the emergence of Saudi Arabia as a swing producer. For those who are more interested in macro-analysis concerning the changes of power in the world oil market, 1972 is an important marker for the development of Saudi Arabia as a swing producer. However, those focusing on microanalysis to explain the relationship between the nationalization of oil and Saudi Arabia's ability to determine production, argue that it first emerged as the principal price-controlling power in the world oil market in 1976. In any case, it is clear that it could emerge as a swing producer at some point during the 1970s. This time period coincides with the emergence of OPEC in the world oil market. During the 1970s, OPEC could effectively control oil prices in the international oil market, opening a new era of oil price regime in oil history. In this transitional period, Saudi Arabia's oil production increased considerably, since it exported most of its oil rather than consuming it

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[11] Wilson et al., *Economic Development in Saudi Arabia,* 43-44.

[12] Anthony H. Cordesman, *Saudi Arabia: Guarding the Desert Kingdom* (Oxford: Westview Press, 1997), 82.

domestically, in contrast with the US, and successfully brought about the nationalization of Aramco. As a result, Saudi Arabia could emerge as a key actor not only in OPEC but also in the world oil market during the 1970s, because it became virtually the only country to be able to affect oil prices.

Before discussing the role of Saudi Arabia as a swing producer in the first half of the 1980s, it is first necessary to discuss the term "swing producer" to understand exactly the positive and negative functions of playing this role in the world oil market. While Rodney Wilson interprets the term swing producer in the narrow and passive sense of being able to vary production levels to satisfy market demand,[13] Anthony Cordesman expands its meaning to include cutting or raising oil production to prevent possible price and supply crises or reduce their impact.[14] Tim Niblock also suggests that the role of swing producer includes undertaking positive activities for the stability of the world oil market by boosting production when the price is high so as to keep it from becoming excessive, and cutting it when it is low in order to prevent a total price collapse.[15] According to their various definitions, these authors seem to use this term in accordance with the logic of the market, focusing on the stability of the oil market. However, they disregard the fact that an oil supplier with a critical casting vote in influencing or determining oil prices can, by controlling its own production, distort the world oil market in its own interest, although this may cause severe damage to market stability. It is important to note that a swing producer has the ability to affect the price of oil by

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[13] Wilson et al., *Economic Development in Saudi Arabia,* 44.

[14] Cordesman, *Saudi Arabia,* 82.

[15] Niblock and Malik, *The Political Economy of Saudi Arabia*, 55-56.

adjusting its production levels to further its own economic and political interests. In particular, the politically motivated oil policy of Saudi Arabia in 1979 made an already tight market situation worse, and gave market forces an opportunity to lead to soaring high oil prices.

The experience of high oil prices during the 1970s had the effect of changing the world oil market into a slack market during most of the 1980s. Oil demand began to fall in 1982, and non-OPEC output gradually increased at the expense of OPEC's market share, challenging OPEC's official prices. In addition, the oil-consuming countries also undermined the OPEC price structure through stockpiling and destocking. With the advent of the economic dogma of neoliberalism, the oil market situations in the 1980s became favorable to market forces and OPEC was in a position to defend its official prices vis-à-vis the increasing influence of both non-OPEC producers and market forces. OPEC's raison d'être as the controller of oil prices was in danger in the 1980s.

With the market situation deteriorating for OPEC, Saudi Arabia was obliged to assume the role of a swing producer. For the first time in OPEC's history, the organization introduced the output-sharing program in March 1982 to defend its official price of $34 per barrel. As Saudi Arabia produced lower than its allocated volume of oil, it was virtually playing the role of a swing producer in 1982. With the increasing downward pressure on oil prices, OPEC lowered its official price from $34 to $29 per barrel in March 1983 and Saudi Arabia officially decided to play a swing producer role without any allocated quota. OPEC's official price of $29 per barrel continued until January 1985 when OPEC decided to lower its official price to $28 per barrel in an attempt to bring non-OPEC countries, particularly the UK, under the OPEC pricing umbrella. OPEC's official price at the levels around $28-$29 per barrel could be achieved because it was acting as a swing producer within OPEC to control oil prices.

Saudi Arabia's oil policy as a swing producer in the first half of the 1980s caused severe damage to its economy. Defending OPEC's official prices required it to carry out a huge cut in output and to sacrifice its market share, which would necessarily be accompanied by a huge fall in oil revenues. As a rentier state like most OPEC members, oil revenues play a decisive role in the Saudi economy. By the end of 1985 oil production had fallen to less than one-third of its 1980 level, from almost 10 million b/d to about 3 million b/d in 1985, falling to 2.2 million b/d in August 1985. Saudi Arabia's market share of OPEC production fell to 20% in 1985 from 37% in 1980.[16] In 1985, Saudi oil revenues were only 28% of what they had been in 1981. To compensate for the fall in its national revenues and to finance its development strategy, Saudi Arabia had to sell off some of its foreign assets; these fell to $87.7 billion in 1985 from $137.7 billion in 1982.[17] Madawi Al Rasheed describes this harsh economic situation in Saudi Arabia as follows:

> Fahd's early years as King coincided with a sharp decrease in oil prices, which reached their lowest level in 1986. The oil price dropped from $32 per barrel to $15 in the early 1980s, thus reducing Saudi oil revenues by over 30% . . . The affluence experienced during the reigns of Faysal and Khalid could no longer be taken for granted, while the Saudi government tried to adjust to decreasing oil prices and oil production that exposed the vulnerability of an economy based on a single commodity. Fahd's early years as monarch were often described as the age of austerity, and contrasted with the years of affluence during the reigns of

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[16] Petroleum & Energy Intelligence Weekly, "PIW's Month-by-Month Breakdown of Total World Crude Oil Production for 1980," *Petroleum Intelligence Weekly* XX, no. 8 (February 23, 1981): 9; "PIW's Estimated Tally of Month-by-Month World Crude Oil and NGL Production for 1985," *Petroleum Intelligence Weekly* XXV, no. 7 (February 17, 1986): 10.

[17] Niblock and Malik, *The Political Economy of Saudi Arabia*, 55-57.

Faysal and Khalid.[18]

This economic downtown in the first half of the 1980s had an enormous impact on Saudi society and politics.

It has been argued that the economic difficulties and burdens faced by Saudi Arabia, such as budgetary deficits and setbacks for its economic development plans, were too heavy for it to continue to carry out its role of swing producer, and in the summer of 1985 it finally decided that it could no longer sustain this role. Although OPEC members agreed to production quotas to control production and prices, it was doubtful whether their expressed willingness was strong enough to make them adhere to the agreements, given their own serious economic problems. Moreover, Iraq, then in the middle of its war with Iran, openly declared that it would not confine itself to any quota set by OPEC. The quota system laid down by OPEC could not prevent member countries from cheating and breaching it. As a result, Saudi Arabia's output in the summer of 1985 was a little more than 2 million b/d, which increased its domestic deficit, and it eventually gave up the role of swing producer by introducing a market related netback pricing system.

Saudi Arabia's decision to change its oil policy toward netback pricing system had a huge impact on the world oil market. The price of oil fell to $10 a barrel by mid-1986 and approximately three-quarters of a million barrels of global oil capacity were eliminated mainly because of the closure of several North American fields, which could not produce oil economically at that level. The cost of this so-called "price war" was high for the OPEC member countries, let alone for non-OPEC producers. Although the price war promised benefits to OPEC in the longer term, given that OPEC member states had

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[18] Madawi Al-Rasheed, *A History of Saudi Arabia* (New York: Cambridge University Press, 2002), 149-50.

much larger oil reserves, the less wealthy members of OPEC had difficulty in taking a long-term view.[19]

King Fahd of Saudi Arabia proposed a fixed price of $18 a barrel in the last quarter of 1986, which was accepted by all OPEC members. Under OPEC's agreement on total production, it decided to impose a production ceiling of 15.8 million b/d for the first half of 1987 and the price of oil reached the benchmark of $18 by mid-1987. However, Saudi Arabia was the only country that stuck to the official price and to its agreed quota between January and June 1987, while other producers were applying market-related prices to produce more oil. After all, Saudi Arabia had changed its oil policy to a formula pricing system combined with the continued quota system of OPEC from June 1987 onwards. It was not easy for OPEC member countries to maintain the stability of oil prices at the desirable levels. Tensions were growing between two groups, one wishing to increase market share and the other wishing to achieve a higher oil price. However, the struggle for price stability continued and the price of oil rose above $20 in April 1989. A price of around $18 a barrel was widely regarded as a benchmark for both oil producing and consuming countries.[20] After the price war in 1986, Saudi Arabia's effort to control oil prices survived briefly because of the difficulties in securing cooperation from OPEC members and non-OPEC suppliers to defend OPEC's official prices. The world oil market entered into new era led by market forces with Saudi Arabia's renunciation of its role as a swing producer and price setter.

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[19] Fouad Al-Farsy, *Modernity and Tradition: The Saudi Equation* (Channel Islands: Knight Communications, 1999), 115-16.

[20] Nourah AbdulRahman Al-Yousef, "The Role of Saudi Arabia in the World Oil Market 1974-1997" (PhD diss., University of Surrey, 1988), 70-72; Al-Farsy, *Modernity and Tradition*, 116.

This dissertation starts with these basic questions: What factors encouraged Saudi Arabia alone to assume the role of a swing producer within OPEC in support of OPEC's official prices in the first half of the 1980s? Why did Saudi Arabia first adhere to OPEC's official price of $34 per barrel and later around $28-29 per barrel (which was relatively high in this period in comparison with the period between 1974-78) at the expense of its own production? If there was some reason for Saudi Arabia to play the role of a swing producer by defending relatively high oil prices, what made it suddenly give up that role in 1985? Although various authors have given different explanations for Saudi Arabia's unique oil policy as a swing producer between 1982 and 1985 and its renunciation of this role in 1985, these explanations do not provide proper answers for these questions. For example, Robert Mabro explained this unique situation by claiming that "OPEC is Saudi Arabia."[21] However, this is only a limited explanation of why Saudi Arabia suddenly gave up its role of a swing producer in 1985, although it knew that this decision would severely threaten the existence of OPEC.

The missing piece of the puzzle piece related to oil history is the reasoning that led Saudi Arabia to assume the role of "swing producer" between 1982 and 1985. Its widely accepted role as a swing producer and the sudden abandonment of this role in the course of the 1980s have remained as unique phenomena in the world oil market until now, without any plausible explanations. To find plausible answers for these questions, I will make use of two analytical approaches. One approach examines Saudi oil policy based on explanations of wealth maximization, focusing on various economic models,

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[21] Robert Mabro, "OPEC after the Oil Revolution," in *OPEC and the World Oil Market: The Genesis of the 1986 Price Crisis*, ed. Robert Mabro (Oxford: Oxford University Press, 1986), 30.

which try to understand the structure of the world oil market and the basic notion of Saudi oil policy from an economic perspective. Another approach explores explanations of nonwealth maximization, focusing mainly on the political and historical context within which Saudi Arabia carried out its swing producer task until the middle of 1985. This category of nonwealth maximization explanations for Saudi oil policy also includes analyses related to target revenue and technical problems, which have rather less persuasive power for the explanation of Saudi oil policy makers' behavior. Finally, from a more eclectic point of view, focusing particularly on the dominant producer model as an explanation of wealth maximization and favoring a political explanation as far as nonwealth maximization was concerned, this dissertation tries to reconstruct the story of Saudi oil policy as a swing producer in a slack market situation in ways that challenge the general notion of Saudi oil policy during the oil boom period. It will provide readers with some tangible reasons for regarding Saudi oil policy as that of a swing producer and indicate certain patterns of this policy in different market situations. From this research, people can predict the possible behavior of Saudi oil policy decision makers under certain market conditions and further anticipate the maneuverability of Saudi oil policy, taking both oil market and political situations into consideration.

Sources

There are few reliable historical sources for the history of Saudi Arabia in the 1980s, especially for charting the socioeconomic and political transitions during this critical period. Although Saudi society experienced dramatic changes in its economy and politics during the 1980s, there is relatively little information about it. Most historians describe the 1980s as the period when Saudi Arabian society and politics became more conservative, to compensate for the weakened political legitimacy of the Āl Sa‘ud. Paradoxically, the rise of a more conservative society in Saudi Arabia during this transitional period encouraged the emergence of the Islamist movement known as the *Sahwa* (awakening) in the 1990s, further undermining the political legitimacy of the ruling family. In spite of the historical importance of this period, the inside story of Saudi Arabia has not been well constructed on proper historical sources. It is very difficult for historians to gain access to reliable data because of the very high level of censorship of the Saudi media and the Internet and multiple restrictions on social research. Therefore, except for a few official documents such as "Achievements of the Development Plans: Facts and Figures" from the Saudi Arabian Ministry of Planning and annual reports from the Saudi Arabian Monetary Agency, which provide some economic data, most of my sources originate outside the kingdom.

For basic data on the Saudi oil industry and the world oil market, the various statistical data sources from OPEC, BP, and *PIW* (Petroleum Intelligence Weekly), *MEES* (Middle East Economic Survey) and F. R. Parra Associates have been used. All these data from different time periods include details of oil production and reserves in the major oil producing countries, both OPEC and non-OPEC producers, world oil demand, the changes in OPEC's official oil prices, spot oil prices and so on. This kind of information will help readers understand the characteristics of Saudi oil industry and the structural changes in the world oil market in the 1970s and the 1980s. Because of the difficulties in getting all this statistical information from one source, different but complementary data from many renowned organizations have been used. Although all these data from various sources do not completely match, and some sources show slightly different figures, these differences can generally be ignored, because they show similar general trends and do not affect the overall outcome of my research. For example, OPEC members' oil production figures from the organization's annual statistical bulletin are generally a little bit lower than those of BP, presumably because OPEC members tended to try to avoid criticism from other members if they exceeded their quotas.[22] On the other hand, the production data of F. R. Parra Associates, which draws on a large number of national, international and trade sources, is similar to that presented by OPEC, because most of F. R. Parra Associates' production data refer to OPEC statistics.[23] Overall, all these statistical data are not contradictory, and each source tends to supplement other statistical sources. The OPEC library in Vienna has most of the statistical data, going as far back as the 1960s and 1970s, as well as various oil industry-related publications such as "Petroleum Industry Investments In The Eighties" by the Chase Manhattan Bank, "Spot Oil, Netbacks and Petroleum Futures: The Emergence of A New Oil Market" published by EIU (The Economic Intelligence Unit), and "Saudi Aramco" published by EIG (Energy Intelligence Group).

Based on the oil data, the decisions of OPEC in the late 1970s and the 1980s should be studied to understand how OPEC members reacted to the changing

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[22] Oil production figures in "BP Statistical Review of World Energy June 2010" include production of crude oil, shale oil, oil sands and NGL (Natural Gas Liquids). In this case, the production of shale oil, and oil sands is negligible in the late 1970s and the 1980s. However, even with the consideration of NGL production figures from F. R. Parra Associates' NGL data, the overall oil production figures are generally higher than those from OPEC.

[23] In Table 1 and 4, the oil production figures of F. R. Parra Associates include NGL. When subtracting the NGL production figures given by Parra from these oil production figures, the result is similar to the crude oil production figures from OPEC.

environment of the world oil market. All these major decisions by OPEC are published in OPEC's *Official Resolutions and Press Releases 1960-1990*, which contains the decisions of the OPEC Conferences and various statements for the 20th Anniversary of OPEC.[24] However, this official information gives only the most limited information on the real reasons behind these decisions and statements, or on the various power struggles between OPEC members during the period. From OPEC's official documents, we can only obtain basic information on the final public agreements among OPEC members.

To find out why OPEC members reached these agreements and to understand how each OPEC member, including Saudi Arabia, managed its own different national interests within OPEC's specific decisions, other analytical and statistical sources should be consulted. As major secondary sources to show the inside story of OPEC in detail, Francisco Parra's *Oil Politics: A Modern History of Petroleum*, Pierre Terzian's *OPEC: The Inside Story*, Benjamin Shwadran's *Middle East Oil Crisis Since 1973*, and Daniel Yergin's *The Prize: The Epic Quest for Oil, Money & Power* will give readers a general account of the history of OPEC, reflecting each member country's national interests in its response to OPEC's official decisions. However, different authors exhibit different attitudes towards OPEC, each with his or her own biases and prejudices. In an attempt to reconstruct OPEC's inside story from an objective perspective, and in an attempt to overcome bias, it will be necessary to reexamine each major country's strategic positions regarding OPEC's decisions, including of course Saudi Arabia's basic positions, through more objective sources of various newspapers, reports and magazines, such as *MEES*, *PIW*, *New York Times*, *Washington Post*, *Financial Times*, and *Wall Street Journal*.

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[24] OPEC, *Official Resolutions and Press Releases 1960-1990* (Vienna: OPEC, 1990).

These sources contain interviews with major players in OPEC, as well as their speeches and their attitudes in response to the changing market and political situations at different times. *PIW* and *MEES* in particular are reliable sources for gaining an understanding of the structural changes in the world oil market and Saudi Arabia's overall oil policy in response to a constantly changing environment. *PIW* provides the analytical insight for informed decision-making in the international oil industry with in-depth analysis and data on significant trends in the global oil market over five decades.[25] *MEES*, recognized as the world's foremost authority on oil and gas in the Middle East region, also provides a comprehensive source of news and analysis on energy, financial and political developments in the Middle East.[26] In addition, various secondary sources on the history of the Middle East will be used to show the political and economic context of the attitudes of each major OPEC member.

After exploring the broad history of OPEC and the world oil market in the late1970s and the 1980s, I will try to find answers to two main questions: first, why did Saudi Arabia play a swing producer role to sustain relatively high oil prices in the first half of the 1980s in spite of the negative effects of this oil policy on its economy? Second, what made Saudi Arabia suddenly give up this policy in 1985? A more detailed analysis of Saudi oil policy in the 1980s will be conducted on the basis of historical materials from the Ronald Reagan Presidential Library in Simi Valley California and the

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[25] Petroleum & Energy Intelligence Weekly, "Information Services: Petroleum Intelligence Weekly," Petroleum Intelligence Weekly, http://www.energyintel.com/pages/about_piw.aspx (accessed March 24, 2014).

[26] Middle East Petroleum and Economic Publications, "About Us," Middle East Economic Survey, http://www.mees.com/en/content/16-about-us (accessed March 24, 2014).

US Department of State. Because of difficulties accessing historical materials in Saudi Arabia and the lack of confidence in the local sources, the primary sources from the Reagan Library and the Department of State can help provide researchers with clues to enable them to reconstruct the history of Saudi Arabia in the 1980s, focusing on Saudi oil policy and the "inside story" of the country.

The historical documents at the Reagan Library and the Department of State relate principally to US energy policies, diplomatic contacts, arms sales, Saudi oil policy and the socioeconomic and political transitions in Saudi Arabia during the 1980s. The various Public Papers of President Ronald W. Reagan and "Oil" folders in box 81 and 82, NSC Executive Secretariat, NSC: Subject File from the Ronald Reagan Presidential Library show the basic principles of US oil policy and the attitude of the US government toward OPEC. In addition, the folder "Saudi Arabia" in box 90998 of the Lucian S. Pugliaresi Files gives a sensitive description of the political changes and power struggles within the Saudi cabinet and shows how the segmented bureaucratic system in Saudi Arabia could challenge the autonomy of the Ministry of Oil and Mineral Resources in implementing its oil policy based on long-term economic interests.[27]

Another folder, "The Vice President's Trip to the Persian Gulf and Arabian Peninsula, April 3-12, 1986" in box 91688, Near East and South Asia Affairs Directorate, NSC Records (1983-1989) contains important information on US-Saudi relations in

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[27] Lucian Pugliaresi served as a staff member of the National Security Council under President Ronald Reagan. He has written extensively on energy and has testified before various committees of the US. See Energy Policy Research Foundation Inc., "Senior Staff: Lucian Pugliaresi," EPRINC, http://www.zoominfo.com/CachedPage/?archive_id=0&page_id=7012926722&page_url=//eprinc.org/senior-staff/&page_last_updated=2014-02-28T20:57:23&firstName=Lucian&lastName=Pugliaresi (accessed March 18, 2014).

1986, US oil policy toward oil prices, particularly after the 1986 oil price collapse, and the economic situation of Saudi Arabia in the middle 1980s. In addition to these primary folders in the Ronald Reagan Presidential Library, other documents from the Department of State, including cables and letters between the US embassy in Riyadh (and the consulate in Jeddah) and the Secretary of State in Washington, D.C., also provide information on Saudi oil policy, the internal socioeconomic and political changes in Saudi Arabia and its political relations with other Gulf states and the United States. After reviewing all these primary sources supplemented by various secondary sources regarding Saudi oil policy, OPEC, and Middle Eastern politics, appropriate answers to my main questions can be found by reconstructing the background of Saudi oil policy in the first half of the 1980s.

Organization of the Chapters

The dissertation is divided into ten chapters. In Chapter I, I show how Saudi Arabia emerged as a key player not only in Middle Eastern politics, but also in the world oil industry during the course of the 1970s and explain its role as swing producer in the world oil market with my own definition of swing producer. After a brief review of Saudi oil policy as a swing producer in Chapter I, I raise some critical questions and outline how to approach theses questions with the appropriate historical materials. The next three chapters (II–IV) focus primarily on providing the basic information for an understanding of the background to Saudi oil policy. After giving a general idea of the primary political and economic factors affecting this policy, I will explore different analytical approaches based on earlier studies in Chapters V and VI. Based on the theoretical and analytical problems and the limitations demonstrated in these two chapters, the next three chapters (VII-IX) provide the reader with detailed answers to my main questions, based largely on primary sources. Finally, Chapter X outlines the general patterns of Saudi oil policy in both tight and slack market situations, answering the main questions of the dissertation within my theoretical framework.

The more informative and descriptive chapters, mainly based on secondary sources, Chapters II, III and IV suggest major internal and external political factors for a consideration of Saudi oil policy, and also show the historical development of the Saudi oil industry and its general characteristics, which show how oil policy was broadly based on the principle of long-term wealth maximization. As three basic political factors, respectively, Wahhabism, alliance with the West and the rentier nature of the state, these have not only consolidated the political power of the Saudi regime, but also enhanced the political legitimacy of the ruling family, and must enter into any account of the implementation of Saudi oil policy. Chapter II focuses on the historical background of Wahhabism and alliance with the West, which contributed decisively to the establishment of Saudi Arabia and analyzes why these two factors are still important for the security of the Saudi regime today. Before discussing the "rentier state" in Chapter IV, Chapter III explores the development of the oil industry and analyzes how its characteristics have played an integral part in an oil policy based on the country's long-term economic interests. In Chapter IV, I discuss the controversial topic of the "rentier state" in academic discourse, focusing particularly on relations between rentierism and democracy. Whether rentierism has or has not hindered the development of democracy in Saudi history, it is clear that the leaders of the state must strongly believe that rentierism has had positive effects on the political legitimacy of the Āl Sa‘ud, because their economic policies have enabled the consolidation of rentierism in Saudi society and economy. Therefore, Chapter IV describes how external rent based on oil exports has effectively changed Saudi Arabia as a rentier state in the course of the twentieth century, and how it has been used for the consolidation of the political power of the Āl Sa‘ud.

For the analysis of Saudi oil policy, Chapter V and VI rely on earlier studies, focusing mainly on wealth maximization and nonwealth maximization explanations for Saudi oil policy. In Chapter V, I discuss the various attempts by economists to understand Saudi oil policy, such as monolithic cartel, property rights, different groups and dominant producer models, and I detail their theoretical problems and the limitations in their application to Saudi oil policy. In particular, a study on the “dominant producer model,” which fits relatively well for the explanation of Saudi oil policy as a swing producer based on its long-term economic interests during the first half of the 1980s, leaves two major questions unanswered. First, why did Saudi Arabia try to achieve relatively high oil prices in a situation in which non-OPEC producers were increasing their market share at the expense of both Saudi Arabia and OPEC? Second, why should the kingdom suddenly give up its oil policy as a swing producer in 1985? To answer these questions, Chapter VI examines another analytical approach to Saudi oil policy based on nonwealth maximization. This genre of analysis not only includes political explanation, but also the target revenue of the government and a number of technical problems in the oil fields as major tools for an investigation of Saudi oil policy. After reviewing these analyses, Chapter VI reaches the conclusion that a political explanation is the only relevant way of explaining Saudi oil policy as a supplementary tool to the dominant producer model, while the other two analyses contradict themselves. However, as previous studies based on political explanations have also failed to provide plausible answers to the main questions in my dissertation, additional research based on primary sources is presented in the next three chapters.

By using various primary sources, Chapter VII, VIII and XI show the structural changes in the world oil market during the 1980s in detail and examine the general principles of Saudi oil policy and the ways in which the government could achieve its oil policy goals under different market conditions, respectively, during the oil boom and during a period of slack markets. In addition, I also analyze how political factors influenced Saudi oil policy in both positive and negative ways. Chapter VII looks into Saudi oil policy during the oil boom period, focusing on its priorities in reaction to the discourse in the oil industry and academic fields and the various political factors that overwhelmed oil policy during a particular period at the expense of the country's long-term economic interests. In Chapter VIII, I discuss the negative effects of Saudi oil policy on the world oil market and the country's consequently decreasing bargaining power. More specifically, I try to show the structural changes in the world oil market during the 1980s, focusing on the decrease in the demand for oil, the increase of non-OPEC production, the stockpiling of oil consuming countries, and the emergence of market forces. Following on from Chapters VII and VIII, Chapter IX analyzes how Saudi leaders' personal perspectives on the world oil market and the political environments at both regional and international levels, accompanied by structural changes in the world oil market, encouraged the Saudi government to play a swing producer role over three years and what made it give up this policy in 1985.

Chapter X provides readers with conclusions about the different ways in which Saudi oil policy took shape, based both on long-term economic and political interests and various political factors, which hindered the implementation of wealth maximization. Following the development of the theoretical foundations for the explanation of Saudi oil policy in the three previous chapters, I try to clarify the answers for the main questions of my dissertation in Chapter X. Finally, from the studies of Saudi oil policy in late 1970s and the first half of the 1980s, I suggest that the possibility of Saudi Arabia joining another Arab oil embargo would be very low under current Middle Eastern political circumstances and even an oil policy based on short-term political exigencies would not have a ripple effect on the world oil market under its current structure in the way that it did in early 1979.

CHAPTER II

THE ORIGINS OF THE SAUDI STATE

To understand Saudi oil policy, we need first to understand the political history of Saudi Arabia, which did not exist as a political entity until the early twentieth century. Hence, before discussing Saudi oil policy we should consider some political factors that had contributed to the establishment of the state, because these factors led not only to the emergence of a new political entity in the Arabian Peninsula, but have also sustained the current Saudi regime by consolidating the power of the Āl Sa‘ud. As these factors have provided the Saudi regime with forms of political legitimacy and have given security to the ruling family, it is hard to understand Saudi oil policy without considering them. There is no doubt that these factors have been important to the rulers of the Saudi state in formulating their political and socioeconomic policies.

The Kingdom of Saudi Arabia was established with the help of Wahhabi religious zeal for *jihad* (holy war), supplemented rather later by the generous financial provisioning of the population through a welfare state and defense policies based on Western support. These three internal and external political factors explain the origins of the Saudi state and the existence of the Saudi regime as an absolute monarchy today, despite constant internal and external challenges to the ruling family. As Michael Nash remarks, “it is the only state in the world which takes its name from its monarchy, with the exception of the principality of Lichtenstein."[1] Although Saudi Arabia is the political outcome of events in twentieth century Middle Eastern history, the monarchy still remains the major source of political power. This outdated political system cannot be understood without a consideration of all the three factors mentioned above, which has sustained the political legitimacy and the security of the Saudi regime.

One of the major internal political factors for the founding of the Saudi state was the "welfare state."[2] ‘Abd al-‘Aziz Ibn Sa‘ud tried to gain the loyalty of the general population as well as the leaders of various tribes in the Arabian Peninsula by providing them with generous economic benefits from the earliest years of the modern state, when he struggled to secure the resources to sustain his welfare state. Although this custom partly contributed to the establishment of the Saudi state by securing the loyalty of the population to ‘Abd al-‘Aziz in the 1930s and 1940s, the welfare state, later replaced by a rentier state, could not have survived without the discovery of large quantities of oil. Therefore, the role of the welfare state in the early Saudi state was quite limited and would not have been possible without the huge inflow of oil revenues.[3]

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[1] Michael Nash, "Contrasting Monarchies: Britain and Saudi Arabia," *Contemporary Review* 287, no. 1678 (November, 2005): 265.

[2] In general, the term "welfare state" is used with the same vagueness as "rentier state" without any precise definition. More precisely, however, it is correct to apply the term "rentier state" to Saudi Arabia in the period after oil revenues began to play a predominant role in political and socioeconomic arena, making taxation unnecessary.

[3] ‘Abd al-‘Aziz provided generous grants and subsidies to Saudi tribes in the early stage of the state, while direct taxes and income from the pilgrimage were still the largest source of income until the mid-1950s. The rentier state has played a decisive role in the consolidation of the Saudi state under the rule of the Āl Sa‘ud since oil revenues became the principal source of government revenue in the late 1950s and 1960s. The differences between a welfare sate and a rentier state will be discussed in Chapter IV. For details regarding ‘Abd al-‘Aziz' financial provisions to the tribes, see Sean Foley, *The*

Another important political factor in the origins of the Saudi state is undoubtedly Wahhabism, an extreme version of Sunni Islam, which has dominated both the religious stage and in the polity in Saudi Arabia. The barren desert territory of central Arabia and the harsh environment with the most meager economic surplus had long left most of central Arabia politically and religiously marginalized from the influence of the outside world, and more particularly of the Ottoman Empire. As a result, some of the major tribal confederations enjoyed autonomy in central Arabia with little or no serious interference from the Ottomans. This context facilitated the emergence of Wahhabism in the region and led to the formation of a lasting alliance between two religiously and politically important figures, Muhammad Ibn ʻAbd al-Wahhab and Muhammad Ibn Saʻud. Since the establishment of the religiopolitical alliance between the two families in the mid-eighteenth century, Wahhabism has provided the Saudi ruling family with legitimacy for its control over the Arabian Peninsula as long as it devotes itself to the implementation of a particular version of Islam in Saudi society. The religious zealotry of the Wahhabis was one of the major driving forces in the conquest of the Arabian Peninsula by providing the Āl Saʻud with political justification in the name of *jihad*.

While appealing to Islam was the best way for the Saudi royal family to secure its political legitimacy in the Arabian Peninsula and to maintain its power over the region, its own practice of Islam has also exposed the Saudi regime to radical opposition from Wahhabi extremists. John Esposito has described the unique situation produced by the often uneasy religiopolitical alliance in Saudi Arabia:

The Saudi appeal to Islam has proven to be a two-edged sword. Islam has been

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Arab Gulf States: Beyond Oil and Islam (Boulder: Lynne Rienner Publishers, 2010), 21-22.

> used as a yardstick by which opponents of the House of Saud have attacked the government.[4]

However, despite sporadic opposition from more radical Wahhabis from time to time, the Saudi royal family has generally maintained its relationship with Wahhabism intact as a means of securing its political legitimacy.

The main reason for the opposition of the Wahhabi extremists to the Saudi regime has been the development of a degree of pragmatism on the part of the Saudi leaders toward the West, particularly with the US, in political, economic and military matters. The decisions of the Saudi leaders to acquire the support of the West, which has sometimes produced conflicts within Wahhabi doctrine, were generally implemented without any serious internal opposition. Although there have been some alarming threats against the Saudi regime such as the seizure of the Grand Mosque in 1979 and the *Sahwa* movement in the 1990s, Saudi leaders have generally been able to manage these threats effectively. As the more mainstream Wahhabi leaders generally accepted the decisions of the Saudi political leadership in the process of establishing the kingdom, and became further subordinate to the ruling family, particularly after the flow of oil revenue towards the religious establishment, the sporadic internal threats against the Āl Saʻud have rarely threatened the political security of the regime.

The alliance with the West has also contributed to consolidate the political leadership of the Āl Saʻud. Although cooperation with the West, first the United Kingdom and later the US, exposed the Āl Saʻud to a degree of risk on some occasions, the overall benefits from the alliance with these infidel countries seem to have been

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[4] John L. Esposito, *Islam: The Straight Path* (Oxford: Oxford University Press, 2005), 193.

enough to counterbalance the political risks associated with it. The alliance with the West helped ‘Abd al-‘Aziz reach a major destination in his long political journey, the establishment of his own kingdom in 1932, which would soon control most of the Arabian Peninsula including the two holy cities of Mecca and Medina, which further enhanced his political and spiritual legitimacy. In addition, the unswerving support of the West has played an important role in guaranteeing the political security of the Saudi regime from internal and external threats during and long after the establishment of the state.

Economic cooperation with the West, particularly the United States, has facilitated the development of the Saudi oil fields, which has brought the Āl Sa‘ud a huge and unexpected fortune from oil production. The windfall revenues enabled the Saudi regime to build all the necessary infrastructures of the modern state and allowed it to enjoy absolute political power by buying off both the religious establishment and the population as a whole. After the Saudi government managed to secure major US investment for the development of the oil industry, Saudi economic interests became more closely connected with the West through the mechanism of petrodollar recycling, especially in the 1960s and 1970s. Their close economic ties with the West generally led the Saudi leaders to implement an oil policy based on mutual benefit.

The Rise of Wahhabism in the Arabian Peninsula

To explain the establishment and the continued existence of the Saudi state in modern Middle Eastern history, an essential first step is to trace the origins of Wahhabism in central Arabia in the middle of the eighteenth century. Wahhabi religious zealotry not only contributed to the establishment of the Saudi state in the barren territory of central Arabia, but also had a vital influence upon Saudi society and politics. It is quite remarkable that this crucial Islamic revivalist movement should have emerged in a politically and religious marginalized region, Najd, during the eighteenth century and that it succeeded in founding the Saudi state, which currently controls most of the Arabian Peninsula.

In terms of the emergence of Wahhabism in the eighteenth century, the context of this period should be understood both in the Muslim world and the broader world of global interactions, because it did not emerge as a unique phenomenon in an isolated environment. Movements of religious revival took place in the eighteenth century not only in the Muslim world, but also in the other major monotheistic traditions. Reformers in the tradition of German pietism, renewal calls in the Great Awakening in the British colonies in North America, the Jansenist revival against the Jesuits and the emergence of Hasidism were all good examples of the appearance of such revival movements at very much the same time.[5]

Although the various Muslim revivalist movements at that time had their own social, political and economic background, they also shared some common interests focusing on the sociomoral reconstruction of society. The eighteenth century witnessed the beginnings of the physical contraction of the Ottoman Empire, mostly at the hands of Austria and Russia, which brought about decentralization, constant military defeats, and economic difficulties. Although the increasing challenge of the West was beginning to be

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[5] John O. Voll, "The Impact of the Wahhabi Tradition," in *Religion and Politics in Saudi Arabia: Wahhabism and the State*, ed. Mohammed Ayoob and Hasan Kosebalaban (Boulder: Lynne Rienner Publishers, 2009), 152-53.

felt, growing European power had not yet dominated the Islamic world at that time and did not yet spur Muslims to initiate revivalist and reformist movements.[6] In this historical context, there were increasing calls for the reform of Muslim society in the eighteenth and nineteenth centuries. On the one hand, some people tried to find solutions to account for the degeneration of their society by resorting to various kinds of modernizing reform, while other religious groups became more conservative in their efforts to find a solution for decline.[7] Therefore, the Islamic revival movements in this period were attempts to solve some of the major internal problems of the Islamic world, focusing initially on the inadequacy of Islamic practice among the faithful, and found their own solutions through attempts to emulate their own versions of early Islamic tradition.

Natana DeLong-Bas explicitly distinguishes the Islamic revivalist movements in the eighteenth century from those in the nineteenth and twentieth centuries. The Islamic movements in the eighteenth century emerged from what their instigators regarded as the endogenous degeneration of the Islamic tradition, into what was regarded as polytheism (*shirk*) or heresy (*bid'a*); on the other hand, those in the nineteenth and twentieth century were largely reactions against European imperialism, and eventually became part of the struggle for national independence. According to DeLong Bas, while *jihad* was not the major purpose of the eighteenth century movements and it was generally confined to notions of self-defense, latter movements encouraged *jihad* to achieve political

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[6] *Islam: Continuity and Change in the Modern World*, Second ed. (Syracuse: Syracuse University Press, 1994), 25-30.

[7] Bernard Lewis, *The Crisis of Islam: Holy War and Unholy Terror* (New York: The Modern Library, 2003), 121-22.

independence and the end of colonial rule.[8]

The Arabian Peninsula had experienced virtual political autonomy for a long time. Apart from British influence in the Gulf and Aden from the 1820s onwards, most of it was not under the direct control or influence of the West. ‘Abd al-Wahhab’s religious movement was local and spontaneous, and began to gain impetus largely as a result of Muhammad Ibn Sa‘ud’s political ambitions. Furthermore, Ibn ‘Abd al-Wahhab and his successors regarded non-Wahhabis, that is, other Muslims who did not follow his narrow and exclusive definition of Islam, as enemies and justified *jihad* against them as one of the prerequisites for implementing true Islamic belief.[9]

Since the weakening of the ‘Abbasid caliphate in the tenth century, Najd had remained largely outside the political orbit of the major Muslim dynasties, because of its remoteness and its lack of population and natural resources. Only a few pilgrims and merchants from Iraq and Iran used the land route across Arabia, which traversed central Najd.[10] During the three centuries before the rise of Wahhabism, this relatively isolated region had experienced nomadic tribal expansion and the growth of small-scale urbanization with the establishment of settlements such as ‘Uyayna and Dar‘iya in the fifteenth century and the settlement of Huraymila in 1635. Expansion by smaller tribes combining into larger federations, the best way to survive in an environment of unending

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[8] Natana J. DeLong-Bas, *Wahhabi Islam: From Revival and Reform to Global Jihad* (Oxford: Oxford University Press, 2004), 8, 12-13.

[9] Ahmad Dallal, "The Origins and Objectives of Islamic Revivalist Thought, 1750-1850," *Journal of the American Oriental Society* 113, no. 3 (July - September, 1993): 349-51.

[10] David Commins, *The Wahhabi Mission and Saudi Arabia* (London: I. B. Tauris, 2009), 7-8.

tribal wars, was one of the major factors contributing to the growth of the small towns in Najd, particularly around the sixteenth century. As these newly settled towns produced an economic surplus, usually from the cultivation of crops such as dates, their *amirs* (chiefs) began to fight over this surplus. In the towns of Najd, the autonomous petty rulers presided over continuous intersettlement and intertribal competition. In this process of forming new frontier zones in Najd, *amirs* in towns sponsored an Islamic intellectual revival to attract recognition of their political legitimacy from the *'ulama*.[11]

Thus, the arguments of Aziz al-Azmeh, Mas'ud Dahir and Ghassan Salame that the Wahhabi movement was a nomadic tribal movement in the form of the religious call to achieve a tribal state allegiance to a particular superior '*asabiyya* (tribal solidarity), seem ahistorical. This mistaken concept is probably the result of the uncritical application of the Khaldunian model to the Wahhabi movement without any analysis of the Saudi state and the Wahhabi movement.[12] Ibn Sa'ud, who founded the religiopolitical alliance with Ibn 'Abd al-Wahhab, was not a nomad, but a member of the sedentary ruling class in the autonomous town of Dar'iya. In addition, the alliance between two families was established on the basis of pragmatism rather than *'asabiyya*. Both leaders had different

[11] Hala Fattah, *The Politics of Regional Trade in Iraq, Arabia, and the Gulf 1745-1900* (Albany: State University of New York, 1997), 22-25; Uwaidah Metaireek Al-Juhany, "The History of Najd Prior to the Wahhabis: A Study of Social, Political and Religious Conditions in Najd During Three Centuries Preceding the Wahhabi Reform Movement" (PhD diss., University of Washington, 1983).

[12] Aziz Al-Azmeh, *Islams and Modernities* (London: Verso, 1996), 144; Khalid S. Al-Dakhil, "Wahhabism as an Ideology of State Formation," in *Religion and Politics in Saudi Arabia: Wahhabism and the State*, ed. Mohammed Ayoob and Hasan Kosebalaban (Boulder: Lynne Rienner Pulishers, 2009), 30-33; Mas'ud Dahir, *al-Mashriq al-'Arabi al-Mu'asir: min al-Badawah ila'l-Dawlah al-Hadithah* (Beirut: Mahad al-Inma al-Arabi, 1986), 273; Ghassan Salame, "Strong States and Weak States: A Qualified Return to the Muqaddimah," in *The Arab State*, ed. Giacomo Luciani (Berkeley: University of California Press, 1990), 34-36.

tribal backgrounds, belonging, respectively, to the tribe of Bani Hanifa (particularly a clan of al-Muqrin later known as Āl Sa‘ud) and the Bani Tamim.[13]

Unlike the Hijaz, Yemen and the eastern coast, central Najd was beyond the control of the Ottoman state, so most Najdi towns had little in the way of a tradition of religious learning. At least since the fifteenth century, most Najdi religious scholars, who belonged to certain family lineages, particularly al-Musharraf, had traveled to Islamic centers such as Medina, Damascus, and Cairo to receive an Islamic education, focusing particularly on *fiqh* (Islamic jurisprudence) and returned to Najd to work as *qadis* (judges) for local *amirs*. They usually trained in the Hanbali *madhhab* and were influenced by the work of Ibn Qudama, Ibn Taymiyya, and Ibn al-Qayyim.[14]

In terms of the religious conditions in Najd during the eighteenth century, there have been different opinions, particularly on the issue of *shirk* (polytheism, idolatry). The two major Wahhabi chronicles, by Ibn Ghannam and Ibn Bishr, regarded the widespread existence of *shirk* in Najdi society as a major obstacle to proper Islamic practice.[15] In contrast with this traditional view of the major motivation for the rise of Wahhabism, Khalid al-Dakhil raises a question about the existence of *shirk* in Najd during this period, pointing out that none of the Hanbali *‘ulama* mention it as a major

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[13] Al-Dakhil, "Wahhabism," 32.

[14] Uwaidah Metaireek Al-Juhany, *Najd before the Salafi Reform Movement: Social, Political and Religious Conditions during the Three Centuries Preceding the Rise of the Saudi State* (Reading, UK: Ithaca Press, 2002), 129-34; Derek Hopwood, "The Ideological Basis: Ibn Abd al-Wahhab's Muslim Revivalism," in *State, Society and Economy in Saudi Arabia*, ed. Tim Niblock (London: Croom Helm, 1982), 25-26.

[15] Al-Dakhil, "Wahhabism," 26; Uthman Ibn Bishr, *'Unwan al-Majd Fi Ta'rikh Najd* (Riyadh: Darat al-Malik 'Abd al-'Aziz, 1982), 33-34; Husayn Ibn Ghannam, *Tarikh Najd*, ed. Nasir al-Din al-Asad (Beirut: Dar al-Suruq, 1985), 13-14.

problem in their writings.[16] It has also been suggested that the emphasis on *shirk* in the work of Ibn Ghannam and Ibn Bishr was strategic rather than "real." This is possible, but in any case the sheer isolation of Najd may have permitted the development of heterodox beliefs and practices, a view suggested by David Commins:

> The religious climate seems to have accommodated a variety of traditions: different Sunni schools of law, coexistence between local custom and norms of Islamic law (*Shari'a*) in everyday life and indifference to the sectarian allegiance of Shi'ite pilgrims from Iran and al-Hasa passing through the region to perform the *hajj*.[17]

It was most likely that *shirk* was widespread in central Najd, which was ruled by a handful of petty rulers whose remote location made them far away from Ottoman control, and this deficiency in Islamic religious practice was one of the main reasons for the rise of Wahhabism. As Peter Sluglett and Andrew Currie argue, activities such as visiting the tombs of saints or invoking their assistance were denounced as *bid'a*, innovation, thus justifying Wahhabi attacks on the Sufi orders, on Shi'ism as well on other forms of "popular Islam." This largely explains the Wahhabis' plunder of the Shi'i shrine city of Karbala in 1801 and their defacing the graves of the Companions of the Prophet in Medina in 1805.[18]

Although the widespread existence of *shirk* in Najd was the probably the principal rationale for the rise of the Wahhabi movement, other dimensions in Najdi society need to be taken into account. According to al-Dakhil's description of the drastic and decisive changes in Najdi society, the region had experienced settlement,

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[16] Al-Dakhil, "Wahhabism," 29.

[17] Commins, *The Wahhabi Mission*, 10.

[18] Peter Sluglett and Andrew Currie, *Atlas of Islamic History* (London: Routeledge, 2014), 65.

resettlement, and the rise of autonomous towns, all of which could be regarded as some form of state formation. Therefore, Wahhabism could be understood as a *hadari* (urban/settled) movement having antinomadic characteristics and it provided the local political leaders with an ideology, the most important factor in the rise of the Saudi state, rather than focusing only on religious learning.[19]

Wahhabism emerged as one of the major Islamic revivalist movements in the eighteenth century, finding answers for the problems of the degeneration of Muslim society by urging the implementation of conservative and fundamentalist religious reforms. This austere Islamic movement, which originated in what were then the fringes of the Islamic world, achieved the greatest success of all Islamist revival movements by establishing a state. In addition, Wahhabism has positioned itself as the most influential and powerful tool in support of the political legitimacy of the Āl Sa‘ud and even in controlling the daily lives of the Saudi people.

Wahhabism and Political Legitimacy

The story of the establishment of Saudi Arabia goes back to the religiopolitical alliance between Muhammad Ibn ‘Abd al-Wahhab and Muhammad Ibn Sa‘ud, which started with an encounter between these two influential men in 1744. Muhammad Ibn Sa‘ud, the ruler of the Najdi town of Dar‘iya, on the outskirts of modern Riyadh, had political ambitions, which coincided with the religious enthusiasm of Muhammad Ibn ‘Abd al-Wahhab who was calling for a return to the simple and pure beliefs of early

[19] Khalid S. Al-Dakhil, *Social Origins of the Wahhabi Movement* (Los Angeles: University of California Press, 1998); "Wahhabism," 33-35.

Islam: austere living, and a strict adherence to *shari'a*.[20] However, while "the ecology of the area where Wahhabiyya originated was austere in the past, the advocates of the movement were partly driven by a desire to amass wealth and treasures from the conquered territories, to compensate for the poverty of their homeland."[21]

Ibn Abd al-Wahhab was born in 1702-3 in the town of 'Uyayna, into a prominent scholarly lineage, al-Musharraf, which provided him with strong religious authority as he inherited the tradition of religious scholarship and training. [22] His religious knowledge was most likely influenced by intellectual trends in Medina, where he studied, which focused on the study of *hadith*, the rejection of Sufism, and strict adherence to a rigorous interpretation of *shari'a*. His experience in Basra in the 1730s may have encouraged his hostility to Shi'ism, particularly its veneration of the *imams*, and led him to place greater emphasis on his version of absolute monotheism (*tawhid*).[23] He insisted that the socio-moral reconstruction of society, particularly the restoration of *tawhid*, should occur through his Islamic movement, and he believed that the best way to achieve his goal would be to place strong emphasis on the direct study of the Qur'an and *Sunna.* Anything that distracts the believer's attention from God, including wealth, statues, or the veneration of saints and their tombs, is *shirk* or *bid'a*, since it involves the worship of something other than God. He rejected *taqlid* (the practice of following the

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[20] Nadav Safran, *Saudi Arabia: The Ceaseless Quest for Security* (Ithaca, N.Y.: Cornell University Press, 1988), 9.

[21] Madawi Al-Rasheed, *Contesting the Saudi State: Islamic Voices from a New Generation* (Cambridge: Cambridge University Press, 2007), 24.

[22] DeLong-Bas, *Wahhabi Islam*, 17-18.

[23] Commins, *The Wahhabi Mission*, 11-12.

interpretations of earlier legal scholars without any question) in favor of *ijtihad* (the individual interpretation of Islamic law) of the scriptures and the *shari'a* by contextualizing them and studying their content.[24]

The local authorities felt threatened by Ibn 'Abd al-Wahhab's revolutionary approach to the study and interpretation of the scriptures and by the potential impact of his movement not only on individuals, but also on the wide public. The more local people were attracted to his teaching, the more this undermined the authority of the local religious establishment. Thus, he was forced to leave towns like Huraymila and 'Uyayna where he had family connections. When he tried to propagate his ideology early in his career of teaching and preaching, the local leadership felt that his public preaching challenged their vested interests.[25]

In much the same way as the Islamic movement of Ibn Tumart in North Africa in the early twelfth century necessitated an alliance with a more practical leader, Almohad 'Abd al-Mu'min, the success of the Wahhabi movement depended on an alliance with a strong political ruler.[26] To implement his ideology, Ibn 'Abd al-Wahhab needed a secular ally who could assist him in protecting and spreading his doctrine. Although he found a political protector in 'Uyayna, 'Uthman Ibn Hamid ibn Mu'ammar, increasing opposition from local Islamic scholars and rulers led him to leave his hometown. He finally found an ally in the ruler of Dar'iya, Muhammad Ibn Sa'ud, and in this way the religiopolitical alliance between the Āl Sa'ud and the Āl Shaykh families (as they are known) was

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[24] DeLong-Bas, *Wahhabi Islam*, 13-19.

[25] Ibid., 19-34.

[26] Hopwood, "The Ideological Basis," 24-25.

formed. Muhammad Ibn Sa‘ud accepted and supported the message of *tawhid*, and the movement gradually gained adherents.[27]

After the conclusion of the religiopolitical alliance between these two important figures, the Saudi domain came to extend over more and more of Najd. The alliance enabled Muhammad Ibn Sa‘ud to acquire legitimacy for his conquests, granting himself and his descendants the power to rule over Najd and its people. Ibn ‘Abd al-Wahhab guaranteed religious blessings to Muhammad Ibn Sa‘ud on the condition that he dedicated himself to the promotion of *tawhid* and the eradication of *shirk*, *jahl* (ignorance), and divisions among the people.[28]

In terms of the configuration of the roles of the ‘*ulama* and the *amirs*, the writings of Ibn Taymiyya (1262-1328) particularly influenced the Wahhabi vision of the ideal Islamic state. He believed that the ideal state should not separate religion and politics, because a secular state would produce disorder.[29] He insisted that there should be two authorities in the ideal Islamic society, respectively the ‘*ulama* and the *amirs*. While the former as the guardians of the *shari‘a* give the *amirs* good advice (*nasiha*) and play a central role in the fields of justice and education, the latter are crucial in enforcing the implementation of *shari‘a* in society, since they are in charge of all political, economic and social activities in accordance with the Qur’an and the *Sunna* as interpreted by the *‘ulama*. Both *‘ulama* and ordinary citizens should obey the rule of the *amir* absolutely,

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[27] Safran, *Saudi Arabia*, 34.

[28] Ibid.

[29] Ann K. S. Lambton, "Law and the State: Islamic Political Thought," in *The Legacy of Islam*, ed. Joseph Schacht and C. E. Bosworth (Oxford: Clarendon Press, 1974), 415.

unless he commands his subjects to contravene the *shari'a*. Although the *amir* should in theory consult the *'ulama* in all his actions, he may also act in accordance with his conscience.[30] In this configuration of the different roles of political and religious figures, the *amir* could enjoy almost absolute political power. This is clear in Ibn Taymiyya's famous saying in his *al-Siyasa al-shar'iya*: "Sixty years with a tyrannical *imam* are better than one night without him."[31]

Although Wahhabi doctrine provided the Āl Sa'ud with political legitimacy, this was not enough to explain why the Wahhabi preacher succeeded in acquiring the support of the ruler in Dar'iya. Madawi Al Rasheed tries to answer this question in two ways. First, the acceptance of Wahhabi doctrine would have provided the Āl Sa'ud with an economic incentive, since 'Abd al-Wahhab promised Ibn Sa'ud substantial *zakat* income. Another possible answer was the rivalry between 'Uyayna and Dar'iya. While the former had enjoyed more superior political and economic power, the latter was in need of political and economic support. Therefore, the ruler of the small town of Dar'iya adopted Wahhabism to solve his own political and economic weakness.[32]

On the other hand, Philby described Dar'iya as dominating Najd, and even the Arabian Peninsula as a whole, in the early eighteenth century,[33] although this seems

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[30] Alexei Vassiliev, *The History of Saudi Arabia* (New York: New York University Press, 2000), 288-90.

[31] Guido Steinberg, "The Wahhabi Ulama and the Saudi State: 1745 to the Present," in *Saudi Arabia in the Balance: Political Economy, Society, Foreign Affairs*, ed. Paul Aarts and Gerd Nonneman (New York: New York University Press, 2005), 17. In Wahhabi terminology, the ruler is also called the *imam*.

[32] Al-Rasheed, *A History of Saudi Arabia*, 18.

[33] Harry St John B. Philby, *Saudi Arabia* (New York: F. A. Praeger, 1955), 30.

highly unlikely. As Vassiliev notes, “there was no large confederation in Najd to play the role of dominant force, and some oases and bedouin tribes preserved their independence.”[34] It seems more reasonable to assume that there was no dominant power in central Najd in this period, and that oasis towns like ‘Uyayna and Dar‘iya would have competed with each other for regional hegemony. In central Arabia, it seems more plausible that an *amir* who had only fragile political and economic power had little to lose by accepting Wahhabism. Whether or not Muhammad Ibn Sa‘ud realized the potential of Wahhabism as a powerful political and militant tool in the future, it was very likely that he regarded it at least as an immediately acquirable aid that could help enhance his political and economic prestige in the race for political and economic supremacy among the towns in Najd.

The religiopolitical alliance between Ibn Sa‘ud and Ibn ‘Abd al-Wahhab in the eighteenth century was used as to justify their own and their successors’ conquest of much of the Arabian Peninsula as a process of continuous *jihad* against neighboring territories; Wahhabism provided the embryonic Saudi state with an expansionist ideology that excommunicated all non-Wahhabi Muslims as unbelievers.[35] However, the efforts of the Āl Sa‘ud and the ‘Abd al-Wahhab families to expand their territory were sometimes challenged not only by the Ottoman Empire, but also by the Rashids of Ha’il and the Hashemites, both competitive and influential families in the region. In the process of the establishment of the Saudi state, the degree of apparently uncontrolled religious zealotry exhibited by the Wahhabis, (together with intrafamily Saudi feuding over the succession)

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[34] Vassiliev, *The History of Saudi Arabia*, 61.

[35] Steinberg, "The Wahhabi Ulama," 14.

was one of the major causes of the collapse of the first and the second Saudi state in 1744-1818 and 1824-1891. John Habib points out the important role of the religious enthusiasm of the Wahhabis for the establishment of the Saudi state:

> While overambitious territorial acquisitions were a factor in the demise of the first Saudi state, Wahhabi fanaticism was the principal reason that led the Ottoman sultan and his Egyptian viceroy to confront and defeat it, two miscalculations that a Saudi prince yet unborn would not repeat . . . While if the first state collapsed because of too much Wahhabi zeal, the second state was the victim of too little.[36]

However, the eventual success of the Wahhabi movement would be its power to mobilize and control its adherents' religious zeal.

The pragmatic tendency of the Wahhabis toward their rulers was clear at the time of the collapse of the second Saudi state; a collapse caused by quarrels over the succession to the throne led in turn to civil war and conflict between rival claimants. All this led to the collapse of the state in 1891 and the conquest of Najd by the Rashid family of Ha'il. Steinberg believes that this bitter experience of the second Saudi state gave the *'ulama* one important lesson, obedience. The '*ulama* realized that they should adopt a more pragmatic attitude toward their rulers in order to make the movement successful, even though they could not always accept their political decisions. They thought that they could avoid a repetition of the devastating political events of the civil war by showing obedience toward their ruler and the leading *'ulama* in Riyadh. As a result, the more pragmatic and defensive approaches of the *'ulama* toward their ruler after the collapse of the second Saudi state made possible the emergence of a strong ruler like 'Abd al-'Aziz

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[36] John S. Habib, "Wahhabi Origins of the Contemporary Saudi State," in *Religion and Politics in Saudi Arabia: Wahhabism and the State*, ed. Mohammed Ayoob and Hasan Kosebalaban (Boulder: Lynne Rienner Publisher, 2009), 59.

Ibn Sa'ud and the establishment of Saudi Arabia.[37]

By the early twentieth century, a ceaseless effort to revive the religiopolitical alliance between the two families finally succeeded in the creation of a new political entity, the Saudi state. Under the charismatic leadership of 'Abd al-'Aziz Ibn Sa'ud, with support from Great Britain and the aid of the *ikhwan* fighters,[38] who had been forged into a capable military force inspired by the principles of puritanical Wahhabism, most of Arabia gradually fell into his hands. After driving the Hashemites out of the Arabian Peninsula in 1925, he signed the Treaty of Jeddah with the United Kingdom and was recognized as king of the Najd and the Hijaz and its dependencies in 1927. Finally, he changed the name of his realm to the Kingdom of Saudi Arabia in 1932.[39]

Although the *ikhwan* played a key role in the military campaign that established the Saudi state, their religious zeal also exposed the Āl Sa'ud to external threats and contributed to its collapse. Although their religious enthusiasm was a major driving force for territorial expansion and acquisition in the Arabian Peninsula during the long journey towards the establishment of the Saudi state, they eventually fell out of control and undermined the leadership of 'Abd al-'Aziz Ibn Sa'ud in the late 1920s. The establishment of the state was only possible after 'Abd al-'Aziz' defeat of the *ikhwan*

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[37] Steinberg, "The Wahhabi Ulama," 18-20.

[38] The *ikhwan* movement emerged around 1913 when 'Abd al-'Aziz Ibn Sa'ud regained al-Hasa. The Wahhabi *'ulama* tried to mobilize nomadic tribesmen for the military campaigns and encouraged the establishment of *ikhwan* settlements in agricultural regions, which played a particularly important role in the campaign against the Hashemites and the Rashids. The *ikhwan* adopted an extremist doctrine and were loyal to their traditional leaders rather than to 'Abd al-'Aziz, and actually rebelled against him in the late 1920s. See Commins, *The Wahhabi Mission*, 80-93.

[39] Safran, *Saudi Arabia*, 9-56.

rebellion in 1929, which involved crucial British help.[40] During the conflict, a large number of *'ulama* joined the king, in spite of the fact that it was the *ikhwan* who were pursuing "true" Wahhabi ideals. After the defeat of the *ikhwan*, the role of the *'ulama* in the political arena was quite limited and they became more subordinate to their ruler.[41]

The pragmatic attitude of the *'ulama* toward their ruler had both negative and positive effects on the consolidation of the political power of the Āl Sa'ud. On the one hand, this pragmatic tendency was partly why the regime's relationship with the West was able to develop without any serious challenge from the religious establishment. This alliance with the West, particularly the United States, and the consequent flow of technical and financial aid from the West accelerated the state's modernization program and the development of the oil industry. This allowed the Saudi ruling family to secure its superior position in the political arena.[42] On the other hand, a combination of scandalous behavior of members of the royal family and the generally pragmatic practices of the religious establishment encouraged radical opposition against both the government and the religious establishment itself. Steinberg describes the unique position of Wahhabism in the Saudi state and the negative effects of the behavior of the religious establishment as follows:

> In the course of over more than 250 years of Saudi history the Wahhabi *'ulama* have developed a noteworthy political pragmatism. To preserve their alliance

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[40] Peter Sluglett and Marion Farouk-Sluglett, "The Precarious Monarchy: Britain, Abd al-Aziz Ibn Saud and the Establishment of the Kingdom of Hijaz, Najd and Its Dependencies, 1925-1932," in *State, Society and Economy in Saudi Arabia*, ed. Tim Niblock (London: Croom Helm, 1982), 42-45.

[41] Steinberg, "The Wahhabi Ulama," 22-24.

[42] The ways in which oil revenues have contributed to the subordination of the religious establishment to the Āl Sa'ud will be discussed in Chapter IV.

> with the rulers, they supported Saudi policy even when it conflicted with their religiously based convictions. This pragmatism has repeatedly led ‘radical’ Wahhabis, who demanded an uncompromising implementation of Wahhabi tenets, to oppose the religious establishment.[43]

While Wahhabism has provided the Saudi ruling family with political legitimacy, the pragmatic attitudes of the *‘ulama* have become a major focus of opposition both towards the religious establishment and the Saudi government.

This pragmatic tendency of the *‘ulama* has been strengthened and accelerated by the lavish financial support they receive from the state. The government tries to ground its political legitimacy through a delicate mechanism calibrated between the ruler and the official *‘ulama* by the application of a massive welfare program. However, the tension between the Saudi government including the official Wahhabis and radical Wahhabis has occasionally threatened not only the legitimacy of the Āl Sa‘ud but even the very existence of the regime. Two major manifestations of this increasing tension were the seizure of the Grand Mosque by Juhayman Ibn Muhammad ‘Utaybi in 1979 and the *Sahwa* movement in the 1990s.

Alliance with the West

It is hard to explain the establishment of the Saudi state purely in terms of the religious enthusiasm of the Wahhabis and the charismatic leadership of ‘Abd al-‘Aziz. In the process of territorial expansion across the Arabian Peninsula which resulted in the creation of the Saudi state, we have to keep in mind that Saudi Arabia was the outcome of an alliance between one colonial power, Britain, and a single prominent family in central Arabia, the Āl Sa‘ud, rather than simply the product of an internal process to consolidate

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[43] Steinberg, "The Wahhabi Ulama," 11.

various tribes under the rule of the Āl Sa‘ud. The establishment of Saudi Arabia was possible precisely because of the support that ‘Abd al-‘Aziz received from the United Kingdom. Initially the alliance enabled him to build his kingdom in the Arabian Peninsula; in time Britain was replaced by the US, and these two countries have maintained a strong relationship for many decades.[44] While the alliance between Saudi Arabia and the West has provided the Saudi regime with economic prosperity and security from external and internal threats, which have considerably contributed to its prosperity today, the activities of a foreign power on the kingdom's "sacred soil" have encouraged opposition to the regime from radical Wahhabis and other opponents of the regime. Therefore, the relations between these two sides are often both precarious and clandestine.

‘Abd al-‘Aziz always sought support from Britain, although Britain had been somewhat indifferent towards him during his early career. After he captured Riyadh from the Āl Rashid in 1902, ‘Abd al-‘Aziz always looked to the British to protect his state from the Ottoman Empire. However, the British were reluctant to intervene in the politics of central Arabia and were more concerned about preserving their other interests in the region, particularly their protectorates on the Gulf and southern coasts of the Peninsula between Aden and Kuwait. As any intervention in Najd could strain Ottoman-British relations and consequently undermine Britain's predominant position in the region, the

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[44] As'ad AbuKhalil, *The Battle for Saudi Arabia: Royalty, Fundamentalism, and Global Power* (New York: Seven Stories Press, 2004), 41.

British did not respond to ‘Abd al-‘Aziz’ overtures for twelve years.[45]

The occupation of al-Hasa was a necessary first step for ‘Abd al-‘Aziz in the process of entering treaty relations with Britain. He realized that he could not secure official protection from Britain unless he occupied al-Hasa where British interests were strongly imbedded. Judging correctly that the British would not allow an Ottoman attack on al-Hasa after he had occupied the region, ‘Abd al-‘Aziz invaded in 1913 without securing any prior understanding with Britain.[46] According to a report from the Russian consulate in Basra, it is unlikely that the conquest of al-Hasa by ‘Abd al-‘Aziz in 1913 would have been possible without Britain’s knowledge or advice,[47] although he did not receive British military support during the campaign. There was no reason for the British to antagonize the Ottomans by cooperating with ‘Abd al-‘Aziz during the negotiation of the Anglo-Ottoman Convention (July 29, 1913), which was designed to secure British interests in the Gulf.

Examining the tactics used in the occupation of al-Hasa, it seems that the military campaign was primarily contrived to attract the attention of the British, while ‘Abd al-‘Aziz tried to leave some room for negotiations with the Ottomans in the worst case of revenge being taken by the Porte. The whole episode showed the cautious attitude of ‘Abd al-‘Aziz toward the Ottomans. He tried to minimize Ottoman hostility towards him by allowing the defeated Ottomans to take refuge in Bahrain, while telling the

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[45] For the details of ‘Abd al-‘Aziz’s overtures to the British, see Jacob Goldberg, *The Foreign Policy of Saudi Arabia: The Formative Years, 1902-1918* (Cambridge: Harvard University Press, 1986), 44-80.

[46] Ibid., 81-86.

[47] Vassiliev, *The History of Saudi Arabia*, 232.

Ottoman authorities that he was obliged to take al-Hasa on behalf of the Porte because of the increasing dissatisfaction of the local population with the oppression of the local Ottoman officials. When he wrote to the British after the occupation of al-Hasa, he showed his dissatisfaction with the British reaction, which was to allow the Ottomans to use Bahrain as a base against him.[48] However, his letter seemed to be strategically devised to draw Britain into the sphere of the bilateral relations between himself and the Porte. In his letter, he revealed his profoundly anti-Ottoman sentiments. At the same time, by not making a counter attack on Bahrain, he showed that he would not threaten British interests in the Persian Gulf.

Although the occupation of al-Hasa did not result in the signature of a treaty with Britain, partly because of the British concern to avoid a possible Ottoman-German alliance which might come about as a worsening of Ottoman-British relations, ‘Abd al-‘Aziz at least succeeded in utilizing British power to counterbalance Ottoman pressure in his negotiations for the settlement of the al-Hasa issue. The failure to secure British protection resulted in the conclusion of a treaty between ‘Abd al-‘Aziz and the Ottomans.[49] For ‘Abd al-‘Aziz, his failure to conclude an alliance with Britain after the conquest of al-Hasa exposed him to the direct threat of an Ottoman invasion, although it was reasonably certain that the Ottomans did not have the money or troops available to recapture the lost province. In addition, it was not easy for the Ottomans to embark on a military campaign to al-Hasa in an area where Britain’s interests were strongly involved.

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[48] Goldberg, *The Foreign Policy of Saudi Arabia*, 85-86; Vassiliev, *The History of Saudi Arabia*, 232.

[49] Goldberg, *The Foreign Policy of Saudi Arabia*, 86-111.

Therefore, the Ottomans sought a face-saving solution.[50]

Using indirect British influence, ‘Abd al-‘Aziz signed the Ottoman-Saudi Treaty in May 1914 on terms that he could regard as generally favorable. Under its provisions, he was nominated as *wali* of Najd, and his territory became a *wilayah*, the highest administrative unit in the Ottoman Empire, while he recognized Ottoman sovereignty over Najd and al-Hasa, allowing the installation of garrisons in al-Hasa of insignificant number and size (both determined by ‘Abd al-‘Aziz) while surrendering any claims to external sovereignty.[51] It would be plausible to see the Ottoman-Saudi Treaty as a face-saving compromise for the Ottomans, giving them nominal rights over Najd and al-Hasa, while giving ‘Abd al-‘Aziz *de facto* autonomy over the region. This treaty bound both the parties not to involve themselves in any disastrous mutual conflict. However, the First World War recalibrated the temporary and unstable relationships between ‘Abd al-‘Aziz, the Ottoman Empire, and Britain.

The First World War led Britain to seek local allies in central Arabia against the Ottoman Empire. Because of British concerns about a possible Saudi-Ottoman alliance against them during the war, ‘Abd al-‘Aziz was able to enter into the first of a number of bilateral agreements with Britain, the Anglo-Saudi Treaty in 1915, which allowed him control over Najd, al-Hasa, Qatif, and Jubayl.[52] As long as he supported Britain against the Ottoman Empire during the war and promised not to invade the smaller Gulf

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[50] Al-Rasheed, *A History of Saudi Arabia*, 39-41; Vassiliev, *The History of Saudi Arabia*, 233.

[51] Goldberg, *The Foreign Policy of Saudi Arabia*, 106-08.

[52] AbuKhalil, *The Battle for Saudi Arabia*, 77-78; Al-Rasheed, *A History of Saudi Arabia*, 42.

principalities, he could acquire financial and military support from Britain.[53] It is clear that such support played a particularly important role in the success of the campaigns of the Āl Sa'ud against the Āl Rashid. For 'Abd al-'Aziz, with British support, the subjugation of the Āl Rashid, who had lost their patron after the defeat of the Ottoman Empire during the First World War, became only a question of time.

After defeating Āl Rashid, 'Abd al-'Aziz embarked on a campaign against Sharif Husayn in the Hijaz, at least partly because of the financial crisis in which he found himself. In March 1924, when the Sharif claimed the caliphate, the British government stopped providing 'Abd al-'Aziz with the subsidy that he had been receiving since early in World War I. As the British government refused him any further requests for financial assistance or loans, he made preparations to invade the Hijaz, which had abundant financial resources including the taxes from the *hajj* and customs duties; he captured Ta'if in September 1924. In this urgent situation, the British government rejected Sharif Husayn's request for support.[54] Although it is probably far-fetched to suggest that the conquest of Hijaz was elaborately engineered by the British government, the end of 'Abd al-'Aziz' subsidy from Britain was most probably a major factor encouraging him to embark on the campaign against Sharif Husayn.

During the invasion, Britain did not openly intervene in the conflict between 'Abd al-'Aziz and Husayn, and this neutrality undoubtedly helped 'Abd al-'Aziz acquire the Hijaz. Al Rasheed suggests that this nonintervention policy was largely because of the

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[53] Shafi Aldamer, *Saudi Arabia and Britain: Changing Relations, 1939-1953* (Reading, UK: Ithaca Press, 2003), 6.

[54] Foley, *The Arab Gulf States*, 22; Sluglett and Farouk-Sluglett, "The Precarious Monarchy," 50.

religious importance of the region and British fears of antagonizing world Muslim opinion.[55] According to Clive Leatherdale, the British government's approach to the Hijaz-Najd war was that it was essentially a religious conflict, and that the British should not interfere in matters between Muslims. In addition to Husayn's general unpopularity among Muslims, the British government was afraid of the negative reaction of Indian Muslims if Britain came to his rescue.[56] These reasons were enough to provide the British government with a sound pretext for not intervening.

Britain's neutrality towards Sharif Husayn meant that British interests in the region no longer coincided with his. During the conflict between two Arab rulers, the removal of Sharif Husayn from the Hijaz seems to have been positively anticipated by the British government.[57] As'ad AbuKhalil argues that 'Abd al-'Aziz' success against the Hashemites could be understood as part of a new British policy in the Middle East, since the great Arab empire envisaged by Sharif Husayn was no longer part of British colonial design for the Middle East after the First World War.[58] As Timothy Paris says, "the King's intransigence over the treaty negotiations persuaded the Foreign and Colonial Offices that Britain would lose nothing if Hussein abdicated, as he had so frequently threatened to do."[59]

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[55] Al-Rasheed, *A History of Saudi Arabia*, 43-47.

[56] Clive Leatherdale, *Britain and Saudi Arabia 1925-1939: The Imperial Oasis* (London: Frank Cass, 1983), 37.

[57] Sluglett and Farouk-Sluglett, "The Precarious Monarchy," 50.

[58] AbuKhalil, *The Battle for Saudi Arabia*, 78.

[59] Timothy J. Paris, *Britain, the Hashemites, and Arab Rulers 1920-1925: The Sherifian Solution* (London: Frank Cass, 2003), 293.

During the 1920s, ‘Abd al-‘Aziz expanded his territory not only as far as the British protectorates of the Gulf but also towards Britain’s mandated territories, Iraq and Trans-Jordan. The British government tried to regulate the borders between ‘Abd al-‘Aziz and Iraq by signing the Treaty of Muhammarah and the ‘Uqayr Protocol in 1922, the Bahra Agreement in 1925 and the Treaty of Jeddah in 1927.[60] Between 1922 and 1927, ‘Abd al-‘Aziz promised three times to curtail aggression against Iraq, and twice pledged to punish those who participated in such actions. After his conquest of the Hijaz in 1925, he realized that he had almost reached the limits of territorial expansion in the Peninsula. Of course, additional territorial expansion, except towards northern Yemen, would imply serious challenges to British protected and mandated territories.[61]

Primarily not to antagonize Britain, ‘Abd al-‘Aziz announced the end of further territorial expansion in the north and east and abandoned further campaigns in these regions by the late 1920s. In addition to prohibiting encroachment into neighboring regions to promote good relations with Britain, he forbade tribal raiding within Najd to bring greater stability to his newly established kingdom. He also pursued a religiously tolerant policy toward the conquered population of Hijaz and promoted the use of modern communication and transport technology such as the telegraph, telephone, radio, and automobile, and airplanes. All these innovations brought economic hardship for the

[60] According to Daniel Silverfarb, “since Iraq was a British mandate and not, legally speaking, British territory, it was not technically covered by this provision of the Treaty of Jidda. However, it was certainly covered if the spirit of the treaty was observed.” See Daniel Silverfarb, "Great Britain, Iraq, and Saudi Arabia: The Revolt of the Ikhwan, 1927-1930," *International History Review* 4, no. 2 (May, 1982): 224.

[61] ‘Abd al-‘Aziz finally acquired ‘Asir in the Southwestern Arabian Peninsula under the terms of the Treaty of Ta’if in June 1934 with Imam Yahya of Yemen. For the annexation of ‘Asir, see Al-Rasheed, *A History of Saudi Arabia*, 70, 100-01.

tribesmen of Najd, undermined their autonomous socioeconomic basis, and ultimately increased their dissatisfaction with ‘Abd al-‘Aziz.[62]

The ending of *jihad* in the 1920s severely compromised the moral and political standing of ‘Abd al-‘Aziz. In terms of establishing close relations with Britain, there was no serious opposition from the *ikhwan* when ‘Abd al-‘Aziz signed the Anglo-Saudi Treaty in 1915, because his own ambitions to expand his territory in the Arabian Peninsula coincided with their interests in propagating their religious doctrine. However, by the mid-1920s, when the *ikhwan* could no longer continue their *jihad* against neighboring regimes under the king's agreements with Britain, which defined the borders between Iraq, Kuwait, Trans-Jordan and Saudi Arabia, they started to challenge his leadership, as has already been described.[63]

In spite of Britain's support for ‘Abd al-‘Aziz against the *ikhwan* rebellion in Iraq, he generally regarded the unfavorable political situation of the late 1920s as an unfortunate by-product of British policy. The British government had established military posts in southern Iraq and launched bombing raids inside Najd, which seriously undermined his political authority. His general suspicion of the British government inclined him to look more favorably towards the US, and partly in consequence of this he awarded his first major oil concession to Standard Oil of California.[64]

Over the decades that followed, on the understanding that it would not intervene

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[62] Silverfarb, "Great Britain, Iraq, and Saudi Arabia," 222-28.

[63] F. Gregory Gause III, "Official Wahhabism and the Sanctioning of Saudi-US Relations," in *Religion and Politics in Saudi Arabia*, ed. Mohammed Ayoob and Hasan Kosebalaban (Boulder: Lynne Rienner Publisher, 2009), 136.

[64] Silverfarb, "Great Britain, Iraq, and Saudi Arabia," 246-48.

directly in the domestic affairs of Saudi Arabia, the US gradually strengthened its relations with the kingdom not only in economic areas such as the development of the oil industry and the establishment of the infrastructure, but also in terms of political and military cooperation. The initial approach of the US to ‘Abd al-‘Aziz was limited to economic areas as the oil company played a major role in communicating between the two governments without any resident officials or US diplomatic presence until the last years of World War II. However, the increasing importance of Saudi oil together with the circumstances of the Cold War positioned Saudi Arabia at the center of America’s Middle East policy. Although this close relationship based on bilateral interests has contributed to the security of the Saudi regime against external and internal threats, the increasing influence of the United States on Saudi society and culture has often undermined the political legitimacy of the government by evoking forms of Wahhabi extremism at the same time.[65] In general, the overall benefits from these close relations with the US are significant enough for Saudi Arabia to be able to shoulder any negative consequences.

As well as being a major source for US oil, Saudi Arabia became a crucial financial supporter of the US during the 1970s. The US had experienced economic difficulties in the 1970s with the combined effects of a free-floating dollar, an increasing trade deficit, and massive debts incurred during the war in Vietnam. All these factors contributed to the volatility and devaluation of the dollar in this period. At that time OPEC started to discuss the possibility of pricing oil transactions in other (i.e., nondollar)

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[65] Thomas W. Lippman, "A Most Improbable Alliance: Placing Interests over Ideology," in *Religion and Politics in Saudi Arabia: Wahhabism and the State*, ed. Mohammed Ayoob and Hasan Kosebalaban (Boulder: Lynne Rienner Publishers, 2009), 125-33.

currencies. This unpublished proposal contained a basket of currencies from the G-10 nations. The US was adamantly opposed to OPEC adopting this policy, and the Nixon administration began to have clandestine high-level talks with Saudi Arabia to make sure that the dollar was maintained as the sole currency for pricing the international trade in oil. Although the US administration assured its European and Japanese allies that no such unilateral monetary arrangement would take place, an agreement between New York and London banking interests was concluded in 1974, in order to establish "petrodollar recycling" and to ensure US economic hegemony. In the same year the Saudi government secretly purchased $2.5 billion in US Treasury bills, and after a few years Treasury Secretary Blumenthal cut a secret deal with the Saudis to ensure that OPEC would continue to use the dollar as the sole currency for pricing oil.[66]

Despite the close cooperation between Saudi Arabia and the West, particularly the US, the Saudi government has been reluctant to publicize these relations. As open cooperation with the US on the part of the Saudi government encourages not only aversion to the West among the population but also engenders strong opposition against the ruling family, the government has tried to keep its relations with the West clandestine or at most unostentatious, and to limit Western contact with the population. In spite of these efforts, the political and economic alliance between Saudi Arabia and the West has sometimes encouraged strong opposition both from Saudi nationals and from the citizens of neighboring Arab or Muslim countries that has often produced at least temporarily strained relations between the two. However, as the interests of the Saudi regime

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[66] William R. Clark, *Petrodollar Warfare* (Gabriola Island New Society Publishers, 2005), 20.

generally coincide with those of the West, close relations have been effectively maintained over a long period.

CHAPTER III

THE SAUDI OIL INDUSTRY

While Islam based on Wahhabism has provided the Āl Sa‘ud with its political legitimacy, the establishment of a rentier state was a necessary material condition for the consolidation of this newly established kingdom in the Arabian Peninsula during the early twentieth century. The rentier state is one of the main pillars sustaining the political legitimacy of the Āl Sa‘ud, and it is closely related to the development of the Saudi oil industry. Therefore, it is necessary to study how the Saudi oil industry began and how it has been developed, and to investigate the general characteristics of the oil industry in the world oil market before discussing the rentier state. The establishment of a rentier state in Saudi Arabia was not possible until the development of the oil industry and the consequent influx of huge oil wealth. The discovery of oil brought political security to the Āl Sa‘ud by attracting political, militant and economic support from the West and by giving the state the means to buy off most opposition groups.

The economic interests of Saudi Arabia in the development of the oil industry have coincided with those of the West. Politically and economically marginalized, the Saudi state desperately needed a source of finance to consolidate its power. Without securing such a source, its disintegration would only be a matter of time. On the other hand, the importance of oil as a primary energy source in the twentieth century encouraged the West, particularly the United Sates, to establish amicable relations based on the continuous guarantee of oil supplies at moderate oil prices. Moderate oil prices and a continuous supply of crude oil are necessary conditions for the prosperity of the world economy.

To understand the broad parameters of Saudi oil policy, the characteristics of the Saudi oil industry should be examined. Notwithstanding the close political, economic and military ties of Saudi Arabia with the US, the economic competitiveness of the Saudi oil industry, based on low cost exploration and production (in comparison with most other oil producing countries), encouraged American oil companies to explore new oil fields in Saudi Arabia, and to develop oil production and transportation facilities to satisfy their own economic interests. These efforts resulted in the discovery of huge oil reserves and the possibility of production with a large excess capacity. The development of Saudi oil produced an oil policy based on moderate prices unlike other OPEC members, because, it was thought, high oil prices would severely damage the future use of Saudi oil and deteriorate the current value of its natural resource by discouraging the use of oil as a major energy source. In addition, an oil policy based on price moderation also coincided with the country's long-term political interests by supporting the consolidation of the regime, as mentioned in Chapter II. Occasionally, when short-term political priorities prevailed over long-term economic interests, Saudi oil policy did not follow this general direction, as shall see in Chapter VI and VII. However, both the economic interests of the Saudi government in general are and were imbedded in an ethos of price moderation that generally satisfies the state's long-term political interests. As Saudi oil production was large enough to influence prices on the world market as a whole, and the economic interests of the state coincided with price moderation, Saudi Arabia was the West's most reliable ally in that it would always stabilize oil prices in the event of any disruption in oil supply or skyrocketing prices.

The Origin of the Saudi Oil Industry

One of major problems faced by 'Abd al-'Aziz that threatened the very existence of his kingdom was his chronic shortage of money. Urgent financial need could be satisfied by *ad hoc* financial assistance by Britain and the US in the early stages of his rule, but this was not sufficient to guarantee the perpetuation of the Saudi state. He needed to secure stable financial resources that would guarantee himself and his family the loyalty of the newly integrated peoples of the Arabian Peninsula. The Saudi oil industry sprang from this financial urgency. The pessimistic view of the British on the oil resources of Saudi Arabia and the relatively minor importance that Saudi oil held for Britain (with its major interests in Iran and Iraq) made it relatively easy for the US to obtain an oil concession. After all, oil was discovered on Saudi territory in 1938 by an American oil company eagerly looking for oil reserves in the Middle East in order to compete with Britain. Therefore, the origin of the Saudi oil industry related mainly to the coinciding economic interests of both Saudi Arabia and the US. Later on, cooperation between two countries based on mutual economic interests expanded into the political arena.

After 'Abd al-'Aziz seized the Hijaz in 1925, he set about a process of political and economic centralization to strengthen his kingdom and to get rid of internal factors of disintegration. The establishment of new institutions and the introduction of modern communication facilities such as the automobile, the radio, and the telegraph helped his efforts. To be equipped as a modern state, he also issued "national" rules and regulations. In 1928, he introduced a new currency, the silver riyal, as part of an effort to establish a single economic entity. These plans for the establishment of a modern state entailed great expense, for which ʻAbd al-ʻAziz raised revenue in a variety of ways. He levied duty on trade both through custom dues and by direct levies on merchants. There were also other ways of making up financial shortfalls such as taxes on animals and dates as well as various types of forced loans. However, the revenue from the pilgrimages was his most important financial source.[1]

Although ʻAbd al-ʻAziz tried to secure sufficient revenue to strengthen the integration of his kingdom, he faced a serious financial crisis in the 1930s. This was caused by badly managed government revenue, considerable problems resulting from the exclusive use of the Saudi riyal, and more significantly the sharp decrease in the numbers of foreign pilgrims due to the effects of the world wide economic depression, as well as the decline of trade, which led to a sharp fall in customs revenue. Thus, it became essential to find additional revenue sources. This crisis led ʻAbd al-ʻAziz to seek out foreign companies which might be ready to reap the rewards of the oil concession in exchange for ready cash.[2]

The first oil concession in Saudi Arabia was granted not to the Americans but to the British. ʻAbd al-ʻAziz had sold an oil concession in al-Hasa province to Major Holmes' Eastern and General Syndicate in 1923, at a time when his situation in Najd was

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[1] Roger Owen and Şevket Pamuk, *A History of Middle East Economies in the Twentieth Century* (Massachusetts: Harvard University Press, 1999), 79-80.

[2] Ibid., 80-81.

still quite precarious and he was beginning to encounter political and financial difficulties in his effort to consolidate his position in the Arabian Peninsula. However, at this stage he was not particularly optimistic that oil would be found in commercial quantities on his territory. The possibility of the potential discovery of oil in Arabia in the 1920s seemed to be negative. Even Sir Arnold Wilson, the General Manager of the Anglo-Persian Oil Company (APOC), did not believe that significant amounts of oil would ever be found in Arabia, and his opinion may have influenced ‘Abd al-‘Aziz. In addition, the opinions of British geologists as well as Heim’s report on the oil possibilities in the province of al-Hasa in 1926 were not encouraging. It is more likely that ‘Abd al-Aziz’ agreement with Major Holmes’ syndicate was not designed to get money directly from oil operations in his realm, but to acquire advances on royalties for his immediate financial needs. In any case, the agreement provided for an annual royalty of a mere £2,000. As the Eastern and General Syndicate had already run out of funds before any serious drilling commenced, Holmes withheld all royalties after paying just £4,000, and ‘Abd al-‘Aziz ended the concession in 1928.[3]

Throughout the nineteenth century, and during World War I, there had been a series of agreements between Britain and a number of Arab rulers in the Peninsula, including ‘Abd al-Aziz. Without British consent, the Arab rulers of small emirates of the Gulf could not enter into political and commercial agreements with other powers or foreign companies. In return, loyal Arab rulers could secure their own positions, as the

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[3] Nelson Robertson, ed. *Origins of the Saudi Arabian Oil Empire: Secret U.S. Documents, 1923-1944* (Salisbury, N.C.: Documentary Publications, 1979), i-ii; Vassiliev, *The History of Saudi Arabia*, 314; Tomas E. Ward, *Negotiations for Oil Concessions in Bahrain, El Hasa (Saudi Arabia), the Neutral Zone, Qatar and Kuwait* (New York: Ardlee Service, 1965), 15.

British provided a degree of protection and an annual subsidy. The agreement with ‘Abd al-‘Aziz came to an end in 1927, although other agreements with the rulers of Bahrain and Kuwait continued into the 1930s.[4] Therefore, it was hard for ‘Abd al-‘Aziz to sign an oil concession agreement with non-British companies until 1927. After the Treaty of Jeddah in 1927, his political maneuverability vis-à-vis the British government increased considerably, and he had the chance to acquire another foreign patron, the United States, as a means of checking the British influence in his territory.

The acquisition of the concession by the Eastern and General Syndicate was based on the mutual interests of ‘Abd al-‘Aziz and the British government. ‘Abd al-‘Aziz was inclined to favor a company with fewer connections to the British government for the oil concession. On December 1, 1922, his adviser, Ameen Rihani, assured Holmes that he had advised ‘Abd al-‘Aziz in favor of the Syndicate and against APOC, which was controlled by the British government, saying that “the less a company applying for a concession had to do with politics the better for the Sultan.”[5] ‘Abd al-‘Aziz could obtain more financial support and more aggressive efforts at oil exploration from a private British oil company rather than the British government-controlled oil company, because his political bargaining power vis-à-vis the British government was quite limited given that the possibility of oil discovery in his territory did not seem to be high. In these circumstances, close British political interest in an oil concession meant less economic benefits and political maneuverability for ‘Abd al-‘Aziz.

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[4] Irvine H. Anderson, *Aramco, the United States and Saudi Arabia: A Study of the Dynamics of Foreign Oil Policy 1933-1950* (Princeton: Princeton University Press, 1981), 7-8.

[5] Ward, *Negotiations for Oil Concessions,* 13.

For its part, the British government was also reluctant to get directly involved in the development of oil fields in the Arabian Peninsula, largely for political reasons. Although the Eastern General Syndicate was a private oil company, it was quite likely that it was working on behalf of the British government rather than competing with APOC. In July 1923, Thomas R. Owens, American Consul in Bagdad, voiced his suspicion that Major Holmes was working indirectly for the British government and Anglo-Persian instead of against them. As circumstantial evidence, he noted that Admiral Slade, President of the Eastern and General Syndicate, was the British government's representative on the board of Anglo-Persian.[6] It is possible that the British government was trying to show a less imperialist image by being less directly involved in seeking oil concessions in the Persian Gulf where the chances of finding oil seemed less, while securing its rights to future concessions through a private British oil company.

In addition to the political reasons for the granting of oil concession in al-Hasa to the Eastern General Syndicate, the British government might have had some economic considerations in this oil concession. In May 1924, George Gregg Fuller, American Vice Consul in Bushire, wrote to the State Department:

> The failure of the Anglo Persian to secure this concession is reported by the British resident to be due to the fear lest the British government grow too powerful in the oil field . . . perhaps the real reason was that they thought the fields would be more quickly developed by a private company which would have to show some return to its investors, whereas a government might merely hold the fields for future use.[7]

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[6] Robertson, *Origins of the Saudi Arabian Oil Empire*, 6; Quoting despatch No. 225 of July 5, 1923 from American Consul Thomas R. Owens in Bagdad, Iraq, to the Secretary of State Washington.

[7] Ibid., 23; Quoting despatch No. 12 of May 31, 1924 from American Vice Consul George Gregg Fuller in Bushire, Persia, to the Secretary of State Washington.

In his opinion, the British government was reluctant to participate directly in the acquisition of a Saudi oil concession for political and economic reasons.

However, it is not clear that the British government really expected high economic benefits to result from an oil concession concluded by a private British oil company in the region, as Fuller mentioned. During the 1920s, as mentioned earlier, there was widespread pessimism in Britain and elsewhere on the possibility of oil discovery in al-Hasa. Therefore, it would seem more likely that the oil concession to the Eastern General Syndicate coincided with the political interests of the British government rather than with any expectations of major economic profits. This oil concession allowed the British government not to bear heavy political burdens by involving itself directly in the oil business without losing the rights to the concession to other foreign oil companies.

After Holmes had failed to find oil himself or to attract other British oil companies to seek concessions in the Arabian Peninsula, oil concessions in Saudi Arabia became more attractive to American oil companies. In addition to postwar concerns over oil shortages, the so-called “open-door policy,” which posited equality of commercial opportunity in independent territories, encouraged the Americans to take more interest in Middle Eastern oil. Obsession with oil shortages was initiated by the experience of World War I, which led the US and its allies to make more effort to satisfy their petroleum requirements. Furthermore, highly pessimistic postwar governmental forecasts for American oil reserves at home directed American attention overseas, particularly to the Middle East. Petroleum became a strategic natural resource, and in mid-1919 the Department of State began to instruct its officers overseas to provide American oil companies with full diplomatic support to secure access to oil. With the diplomatic efforts of the US government in support of the companies' commercial interests, they won a foothold in the development of Middle Eastern oil in 1928 when the final agreement on shares of ownership in the Turkish Petroleum Company (TPC), later known as the Iraq Petroleum Company (IPC), was reached, under which US companies were awarded 23.75% of the shares.[8]

In the early 1930s, 'Abd al-'Aziz' main concern was to stabilize his newly established kingdom under his rule without splitting the various interest groups. During the 1930s and early 1940s, when the US was eagerly looking for oil in the Middle East, 'Abd al-'Aziz exerted his diplomatic talents to get rid of external threats and gave an oil exploration concession to American oil companies, while he tried to keep British influence at a distance. He had largely neutralized the Hashemite threat by coming to an understanding with the British, and from then on he enjoyed the full protection of a major Western power. His greater preoccupation was the danger of the disintegration of his artificially formed territory. He was a charismatic leader, and used his considerable diplomatic talents both to attract foreign support and to find a suitable strategy to appease or deter tribalism and separatism.[9]

All these efforts to prevent any disintegration in his new kingdom, however, might have ended in vain had 'Abd al-'Aziz not been able to solve his financial difficulties. Securing financial security was his most urgent requirement. His charismatic leadership, which had been highly significant in the consolidation of his kingdom in the early stage of the Saudi state, necessarily required financial resources. In the 1930s,

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[8] Anderson, *Aramco, the United States and Saudi Arabia*, 13-21.

[9] Safran, *Saudi Arabia*, 57.

before the discovery of oil, King ‘Abd al-‘Aziz allegedly told his friend and adviser, H. St. John Philby, “If any one offers me a million pounds now, he would be welcome to all the concessions he wants in my country.”[10] It was no exaggeration to say that the continuation of his kingdom as a single political entity largely depended on how well ‘Abd al-‘Aziz could secure his finances.

In the 1930s, the UK still had influence in large parts of the Middle East such as the Trucial States, Southern Arabia, and Jordan, Iraq and Palestine, as well as in southern Persia. However, ‘Abd al-Aziz took the opportunity to strike a deal with the US, as a strategic maneuver to counterbalance the influence of the UK. Ironically, Philby, the king’s British adviser, was the main figure steering ‘Abd al-‘Aziz towards the US oil companies. Philby arranged a meeting with the American philanthropist Charles Crane who in turn sponsored the mining engineer Karl R. Twitchell to search for mineral resources in Saudi Arabia.[11]

In the early 1930s, the possibility of oil discovery in Saudi Arabia increased because of successful explorations in the neighboring regions. Since Twitchell had concluded that the geology of al-Hasa was similar to that of Bahrain, the first successful Bahrain well in 1932 encouraged ‘Abd al-‘Aziz to ask an American oil company to explore his country. Twitchell approached the Texas Company, a joint venture of Standard Oil of New Jersey and Socony-Vacuum, and Gulf Oil Corporation, but none of

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[10] Robert Lacey, *The Kingdom: Arabia and the House of Saud* (New York: Avon Books, 1981), 229.

[11] Melvin A. Conant, *Oil Prices and the Saudi-U.S. Connection* (Washington, D.C.: Conant and Associates, 1991), 1; James Gavin, "The Birth of Oil Giant," *Middle East Economic Digest* 52, no. 2 (January, 2008): 36.

these companies were interested.[12] At that time, Standard Oil of California (Socal), encouraged by the results in Bahrain, enthusiastically contacted Twitchell to develop the al-Hasa area. After the decision of IPC to withdraw its bid because of the high expense of the concession and the uncertainty of oil discovery in Saudi Arabia, Socal bid for a concession in 1933.[13] On Philby's advice, Socal was awarded an oil exploration concession in Saudi Arabia for sixty years. It offered an immediate cash advance of £50,000, an immediate loan of £30,000 ($59,250) to be followed eighteen months later by another loan of £20,000, a further cash advance of £100,000 after discovery, £5,000 annual rent until oil was discovered, and then royalties at the rate of 4 shillings per ton. In return for acquiring oil revenue and exclusive oil rights, US officials reached an agreement which included the employment of Saudi nationals, the construction of roads, towns, and all systems of communication, and exemption from all direct and indirect taxes, imposts, charges, fees and duties including import and export duties.[14]

To execute this agreement, Socal established the California Arabian Standard Oil Company (Casoc), incorporated in Delaware, and invited other American oil companies

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[12] Because of the Red Line Agreement in 1928, which was designed to prevent its partner in IPC from independently seeking oil interests in former Ottoman territories except the sheikhdom of Kuwait, Standard Oil Company (New Jersey) and Gulf found it difficult to participate in the development of Saudi oil.

[13] During the early 1930s, the influence of Great Britain started to diminish in Arabia as ‘Abd al-‘Aziz's power increased, and British businessmen and advisors were gradually replaced by Americans. By 1933, when Washington officially recognized the Kingdom of Saudi Arabia with a Saudi-US agreement on consular recognition, American oil and business interests had priority in Arabia.

[14] Anderson, *Aramco, the United States and Saudi Arabia*, 36; Nicoline Kokxhoorn, *Oil and Politics: The Domestic Roots of US Expansion in the Middle East* (Berlin: Freie Universität, 1977), 50; Robertson, *Origins of the Saudi Arabian Oil Empire*, 75-88.

to join in the development of Saudi oil. This subsidiary, wholly owned by Socal and located in the United Sates, played an important role in the replacement of sterling by the dollar as the company's accounts were kept in dollars, unlike Anglo-Iranian and IPC. As Socal had limited marketing ability, it needed to find a solution through other oil companies. Although Jersey and Shell were interested in Socal's oil concession in Saudi Arabia because of their shortage of crude, they had difficulties in buying the concession under the restriction of the Red Line Agreement. In 1936, Socal sold Texaco a 50% interest in Casoc to gain overseas marketing facilities from Texaco.[15]

In March 1938, oil was finally discovered in commercial quantities in Dammam in the Eastern Province of Saudi Arabia and continuously increasing oil revenues ever since have brought about huge changes in Saudi society and politics. Oil production in Saudi Arabia gradually increased from 495,135 barrels/day (b/d) in 1938 to 3,933,907 b/d in 1939, and 5,074,838 b/d in 1940, but fell to 4,310,110 b/d in 1941 because World War II limited the availability of tankers to handle output.[16] Since the discovery of oil, the Saudi oil industry has effectively developed as the primary oil supplier to the world oil market and the huge inflow of oil revenues into Saudi Arabia has dramatically changed not only Saudi society but also the political relations between the ruling family and its population. This subject will be discussed further in Chapter IV.

The discovery of oil was very crucial for ‘Abd al-‘Aziz in the process of the establishment of his kingdom. As no single political actor had ever controlled the whole Arabian Peninsula including Hijaz and Najd for any length of time, the disintegration of

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[15] Anderson, *Aramco, the United States and Saudi Arabia*, 26-28.

[16] Ibid., 28.

his newly established single political entity would only have been a matter of time without an effective financial base. Oil revenues have allowed the Āl Sa‘ud to control their subjects without any serious rebellions and have strengthened the predominant role of the royal family in every sphere of Saudi society.

The efforts of ‘Abd al-‘Aziz to secure the financial needs of his state finally bore fruit with the discovery of oil in 1938 by American oil companies; Saudi Arabia gradually expanded its close relation with the United States, basically initiated by economic interests, into the political and military spheres. For ‘Abd al-‘Aziz, the discovery of oil was not an option but a necessary condition for the continued existence of his kingdom.

The Development of the Saudi Oil Industry

It was a long journey to obtain financial security for Saudi Arabia by infusing the huge oil revenues into Saudi society as a whole. Financial assistance from the West in the early years of the Saudi state was certainly useful in solving short-term financial problems even after the discovery of oil, but it could not be a long-term solution. The development of an oil industry that could produce the very large quantities of oil whose revenues would transform Saudi Arabia into a rentier state enabled the Āl Sa‘ud to sustain their state without the risk of disintegration.

Although Saudi Arabia’s financial situation improved through oil exports and production and increased tax revenue from the increasing number of foreign pilgrims after the mid-1930s, it would have been impossible to have overcome its economic crisis without British and American assistance until the major increases in oil revenues that came after the war. In the late 1930s, when the British military position in the Middle East was seriously challenged by an Arab rebellion in Palestine and competition from Italy and Germany, which greatly limited its military maneuverability, amicable cooperation with Arab governments in the Middle East was essential to sustain British imperial strategy in the region. In an attempt to secure the goodwill of Saudi Arabia on the eve of World War II, the British government decided to contribute financially to the reconstruction of the Hijaz railway and also provided Saudi Arabia with financial assistance and weapons to induce its benevolent neutrality in wartime, although some of these measures were sometimes frustrated by the opposition of the War Office, India Office or Air Ministry. However, it is hard to say whether any of these measures had any real influence on ‘Abd al-‘Aziz’ benevolent neutrality towards the Allied powers, because he was desperately in need of financial support from the British at the time. Even if he had failed to receive enough financial and military supports from Britain in the late 1930s, he would still have been on the side of the Allies, because there were few options for him except for continuous appeals to Britain.[17]

The outbreak of World War II undermined ‘Abd al-‘Aziz’ two main sources of income: oil and the Mecca pilgrimage. Because of its own wartime requirements, Britain had little room to provide Saudi Arabia with financial assistance. The king requested $6 million from Socal, and the company, unwilling to use its own money, persuaded President Roosevelt to provide an official US loan. With the extension of the lend-lease program in 1943, Saudi Arabia acquired direct financial support from the United States. In February 1943, President Roosevelt noted that “the defense of Saudi Arabia is vital to

[17] Daniel Silverfarb, "Britain and Saudi Arabia on the Eve of the Second World War," *Middle Eastern Studies* 19, no. 4 (October, 1983): 403-10.

the defense of the United States," which enabled 'Abd al-'Aziz to obtain $17.5 million in US funds between 1943 and 1946.[18]

It is no exaggeration to say that World War II accelerated the development of the Saudi oil industry because of Saudi Arabia's increasing strategic importance during the war. The increased political and economic interests of the United States in Saudi Arabia naturally encouraged the growth of the Saudi oil industry.[19] In 1939, US oil investments in Iraq, Bahrain, and al-Hasa accounted for only 10% of all oil production in the Middle East. Until World War II, the economic, political, and strategic importance of Saudi Arabian oil was not clear. However, the war got rid of this uncertainty about Arabian oil as it became a crucial precondition for the Allies' victory, and the war functioned as an important catalyst for the rapid development of Saudi oil production.[20]

During World War II, especially after 1943, Saudi oil facilities were considerably improved to support an Allied victory. Oil production facilities began to expand after 1943. A major new refinery and pier at Ra's Tannurah was completed in 1945 with a capacity of 50,000 b/d, primarily to provide aviation fuel for Allied forces. This brought not only increased oil production but also increased employment for Casoc,

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[18] Benson Lee Grayson, *Saudi-American Relations* (Washington, D.C.: University Press of America, 1982), 13; Owen and Pamuk, *A History of Middle East Economies*, 81, 88; Joe Stork, "Saudi Arabia and the US," *MERIP Reports*, no. 91 (October, 1980): 24.

[19] It took almost ten years to establish diplomatic relations between the US and Saudi Arabia after the United States acquired its oil concession in al-Hasa. Because of increasing American political and economic interests and the increased number of American citizens residing in Saudi Arabia, the Senate finally confirmed Bert Fish's nomination as minister to Saudi Arabia. See Grayson, *Saudi-American Relations*, 8-9.

[20] Shoshana Klebanoff, *Middle East Oil and U.S. Foreign Policy: With Special Reference to the U.S. Energy Crisis* (New York: Praeger Publishers, 1974), 10.

which grew from 2,882 in 1943 to 11,892 in 1945. As the oil company became a technical adviser as well as a major financial supplier to the kingdom, the Saudi government tried to maintain a close relationship with it.[21]

As the economic and strategic importance of oil increased during wartime, the US government tried to secure foreign oil reserves through a publicly owned corporation. In an attempt to participate in the development of foreign oil reserves, the US government planned to buy out Casoc's entire equity in the 1940s. However, the US government failed to buy a share in Casoc, later renamed the Arabian American Oil Company (Aramco) in 1944, because of opposition from US oil companies, citing the traditional noninvolvement of the government in business enterprises. In the end, instead of direct involvement in the oil business, the US government sought to provide the private American oil companies with diplomatic and political assistance and support to expand their operations in Saudi Arabia and other Middle Eastern countries. For example, the US government played an important role in the purchase of equity shares in Aramco by Standard Oil of New Jersey and Socony in 1948 and Aramco's 50-50 profit-sharing agreement with the Saudi government in 1950.[22]

According to Joe Stork, US policy, jointly formulated by corporate and government officials was designed to achieve two main goals in the Middle East after World War II as follow:

> The first was to maintain and expand US control of Middle Eastern reserves, particularly against greatly exaggerated British competition. A second goal was to increase Middle East production and "to substitute Middle Eastern oil for

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[21] Owen and Pamuk, *A History of Middle East Economies*, 87-88.

[22] David E. Long, *The United States and Saudi Arabia: Ambivalent Allies* (Boulder: Westview Press, 1985), 14-16.

Western hemisphere oil" in Europe and other "eastern hemisphere markets.[23] The development of Saudi oil was crucial in implementing this policy and the US government either directly or indirectly supported the expansion of Saudi oil production.

To achieve these goals, the infusion of extra capital into Aramco was desirable and the acquisition of additional funds contributed to the expansion of Aramco's operations and markets. The best way to secure additional funds for Aramco was to encourage other American oil companies to participate in Aramco's equity and for the US government to provide them with diplomatic and legal assistance. Eventually, two other major American companies came to participate in Aramco. Standard Oil of New Jersey (known as Exxon) and Socony Vacuum (known as Mobil) gained an interest in Aramco in 1948 after setting aside the Red Line provisions, while they opened their extensive European markets to Aramco and provided capital for projects like the Trans-Arabian Pipeline (TAP line). The composition of Aramco ownership between these four major American oil companies until 1972 was as follows: Texaco (30%), Chevron (30%), Exxon (30%), and Mobil (10%).[24]

The development of the Saudi oil industry in the 1950s advanced considerably with the discovery of new oil fields and the completion of the TAP-line. In 1951, oil was discovered in Safaniya, the company's first offshore field and one of the largest in the

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[23] Stork, "Saudi Arabia and the US," 24.

[24] Al-Yousef, "The Role of Saudi Arabia," 20; Long, *The United States and Saudi Arabia*, 17; Giacomo Luciani, *The Oil Companies and the Arab World* (London: Croom Helm, 1984), 19; Stork, "Saudi Arabia and the US," 24.

world, and Saudi Arabia became the leading Middle East producer (see Table 1).[25] The Ghawar oil field, which included ‘Uthmaniyah, ‘Ayn Dar, Hawiyah, and Haradh and the continuous oil reservoir beneath these locations, was developed during the early 1950s. It is one of the largest onshore oil fields, no less than 150 miles long and up to 22 miles wide. The average daily oil production of this giant oil field in 1956 exceeded one million barrels. Another important oil field was discovered at Khursaniyah in 1956, and two other major oil fields were found at Khurais in 1957. The completion of the pipeline from Abqaiq in Saudi Arabia across Jordan and Syria to Sidon in Lebanon enabled Saudi Arabia to export 15 million tons of oil per year.[26]

Another important development was the so-called “50-50 Agreement” in 1950. This 50-50 profit sharing was influenced by the introduction of Venezuela’s Hydrocarbons Law in 1943 largely because of increased US concern about the possible copycat effect of Mexican nationalization in Venezuela and the strategic importance of Venezuelan oil, particularly during World War II. After the outbreak of the Korean War in June 1950, the stability of Middle Eastern regimes, particularly Saudi Arabia, became vital to the national security of the US. On the Saudi side, its financial difficulties encouraged the government to renegotiate with Aramco for additional revenues.

In this period, Saudi Arabia was suffering financially from the high propensity of sterling countries to acquire oil from British sources. This was mainly due to an

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[25] During the 1950s and the first half of the1960s, the production of Kuwait had exceeded the output of Saudi Arabia. However, since 1966, Saudi Arabia became and has remained the leading oil producer in the Middle East except for 1969, when Iranian production slightly exceeded that of Saudi Arabia.

[26] Bryan Cooper, ed. *OPEC Oil Report* (London: Petroleum Economist, 1977), 228.

Table 1. Oil Production of Major Middle Eastern Countries 1950-1979.
(Thousand Barrels/Day)

Year	Iran	Iraq	Kuwait	Saudi Arabia
1950	660	140	344	547
1951	338	181	561	762
1952	20	389	747	825
1953	27	581	862	845
1954	60	636	960	962
1955	330	697	1,104	977
1956	540	641	1,109	1,003
1957	730	450	1,172	1,031
1958	829	731	1,436	1,059
1959	940	857	1,441	1,153
1960	1,068	972	1,692	1,314
1961	1,202	1,007	1,735	1,480
1962	1,335	1,009	1,960	1,643
1963	1,491	1,162	2,101	1,789
1964	1,711	1,255	2,308	1,905
1965	1,908	1,313	2,370	2,217
1966	2,132	1,392	2,504	2,615
1967	2,603	1,228	2,521	2,823
1968	2,840	1,504	2,653	3,081
1969	3,376	1,523	2,816	3,259
1970	3,848	1,549	3,039	3,852
1971	4,540	1,694	3,244	4,814
1972	5,023	1,466	3,333	6,065
1973	5,908	2,026	3,074	7,684
1974	6,022	1,971	2,597	8,603
1975	5,350	2,262	2,127	7,201
1976	5,918	2,422	2,199	8,762
1977	5,714	2,358	2,026	9,419
1978	5,302	2,574	2,184	8,554
1979	3,203	3,489	2,554	9,841

Data Source: Table 3-1, 3-2, 3-3 and 3-4 in F. R. Parra Associates, "The International Oil Industry."

Note: Oil production data include NGL Production. World NGL production only accounted for 4.4% of world oil production in 1973 and 5.5% in 1979.

international dollar shortage and the less favorable terms of Aramco's concession in comparison with the terms of oil concessions in other countries. This included another Saudi oil concession, the Getty concession, concluded in February 1949 in the Saudi-Kuwaiti neutral zone. The Saudi government finally reached a 50-50 profit-sharing agreement in November 1950. Under its provisions, the Saudi government could acquire half of Aramco's net operation revenue and impose Saudi taxes on Aramco's profit. According to its original concession agreement in 1933, Aramco was exempt from all forms of taxation, with the exception of royalty and rental payments. However, there was no strong opposition from Aramco, because any Saudi income tax paid by Aramco could be credited against US income taxes, as had happened for Venezuela. This was the first Middle Eastern agreement of its kind, and had repercussions for the whole oil industry in the Middle East. The agreement greatly increased government revenue with these new taxes. While the profit sharing did not reach quite 50-50, it contributed to the solidification of the relationship between Aramco and the Saudis.[27]

Although the development of the oil industry in the1960s was less dramatic than in the previous two decades, Aramco still discovered seven new offshore fields and the Saudi government began to diversify its sources of income outside petroleum during this period. In addition to the Abu Sa'fah, Berri, and Qatif offshore fields, four new fields were found in Zulluf. As a result of the continuous discovery of oil fields, Saudi oil production increased from 1.3 million b/d in 1960 to over 3.2 million b/d by the end of

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[27] Cooper, *OPEC Oil Report*, 229; Long, *The United States and Saudi Arabia*, 18-19; Francisco Parra, *Oil Politics: A Modern History of Petroleum* (London: I. B. Tauris, 2010), 14-21; Stork, "Saudi Arabia and the US," 24; Louis Turner, *Oil Companies in the International System* (London: The Royal Institute of International Affairs, 1980), 47-49.

1969 (see Table 1). For the development of the state's natural resources other than petroleum, the General Petroleum and Mineral Organization (Petromin), a government owned public company under the supervision of the Ministry of Petroleum and Mineral Resources, was established in 1962 for the development of petroleum and other minerals. Its activities expanded to the distribution of petroleum products throughout Saudi Arabia as a main agent for refined products. In addition, Saudi Arabia reached a new agreement with Kuwait regarding the partition of the Neutral Zone in 1964 and also reached agreements with Qatar and Iran on the demarcation of their respective borders between 1966 and 1968.[28]

During the 1950s and 1960s, world demand for oil had continuously and rapidly increased. Total world oil demand was 10,763 thousand b/d in 1950 and it reached 43,695 in 1969 (see Table 2). Although the history of oil is relatively short, its growth and development are quite dramatic in modern commercial history. As an energy source, crude oil has many advantages over other energy forms such as coal and has been widely used in daily life, because it is easy to extract and to transport from one place to another by tankers or pipelines and it causes less environmental problems than most other energy sources including coal and nuclear energy. In addition, crude oil has been used not only for energy sources such as diesel oil, gasoline, kerosene and gas oils and aviation and jet fuels but also for nonenergy uses such as fertilizers, plastics of all kinds, synthetic fibers and synthetic rubber, adhesives and so on through various refining processes. Particularly, the wide spread use of gasoline in transport and rapidly increasing world car ownership during the 1950s and 1960s resulted in a tremendous expansion in the demand

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[28] Cooper, *OPEC Oil Report*, 229-31.

Table 2. World Oil Demand 1950-1989. (Thousand Barrels/Day)

Year	Demand	Year	Demand	Year	Demand	Year	Demand
1950	10,763	1960	22,025	1970	46,370	1980	62,259
1951	12,043	1961	23,475	1971	48,957	1981	60,852
1952	12,675	1962	25,458	1972	52,452	1982	59,454
1953	13,467	1963	27,191	1973	56,715	1983	58,682
1954	14,344	1964	29,397	1974	56,820	1984	60,007
1955	16,057	1965	31,640	1975	56,057	1985	59,867
1956	17,434	1966	34,218	1976	59,152	1986	61,570
1957	18,210	1967	36,753	1977	61,724	1987	62,864
1958	19,084	1968	40,006	1978	63,875	1988	64,323
1959	20,375	1969	43,695	1979	65,028	1989	65,641

Data Source: Table 10-1, 10-2, 10-3, 10-4, and 10-5 in F. R. Parra Associates, "The International Oil Industry."

for gasoline. All these developments in the oil industry have meant that oil accounted for about half of all commercial energy consumption by the early 1980s. As a result, oil became the largest single commodity in international trade in the twentieth century and positioned itself at the very center of the world economy.[29]

Although the oil industry is a lucrative business ensuring great financial rewards, it is not open to participation by many corporations because of its unique characteristics. The oil industry requires capital involvement on a huge scale for its exploitation and development and it is the largest industry in the world in terms of capital expenditure. In addition to its huge capital requirements, the exploitation and trade of oil is quite complex and sophisticated. Therefore, many of the commercial companies dealing with

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[29] OPEC, *Basic Oil Industry Information* (Vienna: OPEC, 1983), 2-3, 28-36.

oil all over the world are some of the largest.[30] Historically, these characteristics of the oil industry meant that the international oil market was controlled by a small group of companies without free competition for a long time. In 1975, Anthony Sampson argued that until the early 1970s the international oil market resembled a cartel composed of a small group of multinational oil companies, the so-called "Seven Sisters," rather than perfect competition.[31]

With the establishment of OPEC, rapidly increasing oil demand during the 1960s accelerated the emergence of a new price regime. Robert Mabro has analyzed the history of world oil by distinguishing two different regimes.[32] According to him, the major oil companies largely controlled oil prices in the international oil market in the 1950s and 1960s. During this first period, the oil industry was characterized by a high degree of concentration and integration. The major oil companies were able to match supplies to anticipated demand through a highly planned system without any serious interference from the oil producing countries. In these circumstances, oil prices would remain stable

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[30] Colin Carter and Patrick Keenan, "Petroleum Industry Investments in the Eighties," (New York: The Energy Economics Division of the Chase Manhattan Bank, N. A., 1983), 2; OPEC, *Basic Oil Industry Information*, 36.

[31] Anthony Sampson, *The Seven Sisters: The Great Oil Companies and the World They Made* (New York: Viking Press, 1975); Enrico Mattei, the head of the Italian State Oil Company (ENI), first described these major international oil companies, composed of four Aramco partners, Jersey (Exxon), Socony-Vacuum (Mobil), Standard of California (Chevron), and Texaco, together with Gulf, Royal Dutch Shell and BP, as "the Seven Sisters." They dominated the world petroleum market until the 1970s. See Daniel Yergin, *The Prize: The Epic Quest for Oil, Money & Power* (New York: Free Press, 1991), 503.

[32] His analysis could be only applicable to the oil market before 1986. Since the 1986 oil price crisis, the oil price regime controlled by OPEC has rendered its power to market forces. The current oil market is dominated by a market-related oil-pricing regime.

with little fluctuation, because the companies could meet the variations in demand by operating under their own elaborate planning system.[33] However, during the 1960s, after the establishment of OPEC, which began to exert its very limited and defensive power vis-à-vis the major oil companies, the expansion of oil demand gave opportunities for smaller independent oil companies to enter into the downstream market and compete with the majors there, although the majors still kept their predominant position upstream.[34] However, their increasing power in the oil industry started to undermine and challenge the predominant position of the Seven Sisters. As a result, the first oil price regime came to an end during the 1970s and the power balance between the oil producers and the companies became more favorable to the former.

Skyrocketing world oil demand not only provided the smaller independent oil companies with access to the world oil market, but also enabled the oil-producing countries to have much greater leverage vis-à-vis the major oil companies and gave them a golden opportunity to control oil prices by nationalizing their own oil industries. Gause has described the changing situation of the world oil market in the 1970s, comparing the situation with the previous decades, claiming that the market's tilt in favor of the oil producing countries has allowed them, instead of the oil companies, to have the predominant role in determining oil prices:

> Whereas in the early 1950s lost Iranian oil production could be easily replaced from other sources, by 1970 there was limited spare oil production capacity anywhere in the world. Oil production in the United States peaked in 1970. US imports of oil increased dramatically from the late 1960s. World demand for oil and world supply of oil had come into a precarious balance. That change gave

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[33] Mabro, "OPEC's Future Pricing Role," 57-58.

[34] "The Nature of the Energy Problem," 45.

producer governments more power in their dealings with oil companies.[35] In addition to increased oil demand, considerably reduced spare oil production capacity, which caused tight supplies, contributed to the end of the first oil price regime.

A new price regime finally emerged in the 1970s, allowing the world oil market to separate sellers (represented by OPEC) and buyers. This phenomenon was consolidated by the Arab oil embargo of 1973 and the second price regime also encouraged market forces to increase their role in international oil trade. This structural change in the world oil market led to the end of the control of oil prices by the major oil companies, and surrendered the power of price control to a dominant institutional agent, OPEC. At the same time, the maneuverability of market forces was considerably increased and this sometimes led to a price collapse in a slack market or a skyrocketing oil price in a tight market.[36]

During the 1970s, when the oil-producing countries started to take over their own oil industries from the major international oil companies, Saudi Arabia also tried to nationalize Aramco. In 1976, the Saudi government, which already possessed 25% of Aramco's assets, began a systematic program of purchasing the remainder, a process, which was completed by 1980. However, Aramco still remained incorporated in the United States. The four major American oil companies continued to participate in producing, refining and exporting crude oil and natural gas based on a fee-for-service basis during a transition period. By 1988, Aramco became a totally state-owned Saudi company and its name was changed to the Saudi Arabian Oil Company (Saudi Aramco).

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[35] F. Gregory Gause III, *The International Relations of the Persian Gulf* (Cambridge: Cambridge University Press, 2010), 26.

[36] Mabro, "OPEC's Future Pricing Role," 58-59.

In the same year, its headquarters moved to Dhahran, and Saudi Aramco now controls all upstream and most downstream operations.[37]

Saudi Arabia took over its oil industry in the course of the 1970s and the state was then able to decide on its oil production level and oil prices, reflecting its own political and economic interests. With its large quantity of oil production and reserves in comparison with other oil producing countries and with the nationalization of Aramco, Saudi Arabia positioned itself not only at the center of Middle Eastern politics but also of the international economy. As we shall see in Chapter VI, the decisions of Saudi oil policy makers could not be free from the influences of both Middle Eastern politics and the interests of its old patron, the US. Increasing pressures from neighboring Middle Eastern countries led Saudi Arabia to participate in the 1973 Arab oil embargo and to decide to reduce oil production in 1979, which resulted in skyrocketing oil prices. However, when the kingdom was relatively free from pressures from other Middle Eastern countries to increase oil prices and was in need of military assistance from the West, particularly the United States, it tried to stabilize oil prices by producing more oil to satisfy its own political and economic interests.

Characteristics of the Saud Oil Industry

The development of the Saudi oil fields was initiated and accelerated on the basis of the mutual interests of Saudi Arabia and the US, and the size of the Saudi oil industry was large enough to position the kingdom at the center of the world oil market. Since the discovery of Saudi oil in commercial quantities in March 1938, Saudi oil fields have been

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[37] Cooper, *OPEC Oil Report*, 229, 391; Jareer Elass, *EIG Special Report on Saudi Aramco* (New York: Energy Intelligence Group, 1999), 13.

dramatically developed by the Aramco group of American majors, Exxon, Chevron, Mobil and Texaco. These companies had enough financial resources, technical know-how and marketing networks to manage operations until the Saudi government took it over. The exploration and development of the Saudi oil fields were strategically important for the commercial and political interests of the US. The development of the oil industry was also crucial for the existence of Saudi Arabia during its early days, because it provided the newly established state with the inflow of huge amounts of money as a stable financial resource. Fortunately, the size of the industry was big enough to satisfy the needs of both parties. With increased oil demand in the world economy and the nationalization of Aramco, Saudi Arabia, with its enormous production capacity and reserves, emerged as one of the most important and influential countries in the international oil market.

According to Thomas McHale, the main reason that Saudi oil policy has received significant attention from the world was the unique characteristics of its oil industry in comparison with other oil producing countries. While Saudi oil reserves and production capacity are sufficient to put the country in a strategically important position in the international oil market, the costs of oil production and exports are among the lowest in the world.[38] The competitive size of the Saudi oil industry and its cost advantages over other producers has enabled the government to exert considerable influence on the international oil market, which has shown a relatively inelastic demand for oil in the short-term. It was clear that the oil-producing countries, particularly those represented by

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[38] Thomas R. McHale, *Saudi Oil Policy and the Changing World Energy Balance* (Boulder: International Reserach Center for Energy and Economic Development, 1986), 1.

OPEC, would not be able to secure higher oil prices, which provided them with increased revenues in the short-term, without the cooperation of Saudi Arabia. However, oil-importing countries, including the US, could also not stabilize oil prices without an “amicable” Saudi oil policy.

Proven oil reserves in Saudi Arabia have steadily increased after the first discovery of oil in 1938. The discoveries of giant oil fields in the late 1940s and early 1950s gave Saudi Arabia enormous reserves of crude oil. Proven oil reserves in Saudi Arabia increased sharply during the second half of the 1940s from 2,000 million barrels in 1944 to 9,000 million barrels in 1949. The continuous development of the oil industry allowed Saudi Arabia to be the number one country, with the largest proven oil reserves in the world in 1967 with 74,700 million barrels. While the proven oil reserves of the United States had slightly increased slightly from 20,064 million barrels in 1944 to 25,860 million barrels in 1989, Saudi proven oil reserves increased dramatically from 2,000 million barrels in 1944 to 254,959 million barrels in 1989. In 1989, Saudi oil reserves accounted for one-quarter of total proven world oil reserves.[39] Even in comparison with the increase of proven oil reserves in other major oil producing countries, the achievement of the oil industry in Saudi Arabia was quite immense.

Saudi Arabia was able to achieve this dramatic increase in oil reserves largely because of its economic advantages in exploration and development. The concentration of the oil bearing strata in a relatively small geographic area, the gigantic size of the oil fields, and the relatively high pressure of associated gas in most of the fields allows Saudi Arabia to lower drilling and operating costs in comparison with other oil producing

[39] F. R. Parra Associates, "The International Oil Industry." See Table 1-1, 1-2, and 1-5.

countries.[40] These economic advantages have encouraged international companies to participate enthusiastically in exploration and development, and have enabled Saudi Arabia to secure huge amounts of oil reserves.

In addition to the large size of oil reserves with low-cost extraction, the expansion of related facilities for production and transportation has contributed to the increase in production capacity but also to low average and marginal production costs.[41] In the 1970s, Aramco tried to meet increasing world oil demand by expanding its operating facilities and strengthening its exploration program. At the end of the 1960s Saudi Arabia produced about 3 million b/d, but, its production capacity would increase dramatically during the course of 1970s and it produced over 10 million b/d in 1980 and 1981,[42] largely because of the newly discovered reservoirs and the establishment and expansion of producing, refining, and shipping operations. Between 1972 and the end of 1975, Aramco built more than 800 miles of pipeline for inland oil transportation, drilled about 1,000 deep wells, and established 24 gas-oil separator plants and the Ju'aymah oil terminal at which 4,470 tankers could be loaded.[43] To cope with increased oil production, refineries were also built in Jeddah in 1968 and in Riyadh in 1975.[44] In 1976, Aramco became the only oil company in the world that could produce more than 3 billion barrels

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[40] McHale, *Saudi Oil Policy*, 3.

[41] Ibid., 3-4.

[42] F. R. Parra Associates, "The International Oil Industry." See Table 3-3 and 3-4.

[43] Ismail I. Nawwab, Peter C. Speers, and Paul F. Hoye, eds., *Aramco and Its World: Arabia and the Middle East* (Washington, D.C.: Arabian American Oil Company, 1980), 214.

[44] Cooper, *OPEC Oil Report*, 230.

of crude oil in a year.[45] All these developments enabled the Saudi oil industry to keep average costs per barrel under 50 US cents at high levels of facility operation.[46]

About one-fourth of the world's proven oil reserves possessed by Saudi Arabia and its huge production capacity, including its excess capacity, placed it in a pivotal position for setting posted prices within OPEC. On December 23, 1973, an OPEC press release described Arabian Light 34° API as the Marker Crude for the first time. In an attempt to administer oil prices, OPEC tried to set the price of one single type of crude, Arabian Light 34° API, as the base from which other OPEC members could calculate their own crude values by taking account of each member's own crude oil quality and locations in comparison with the Marker Crude.[47] Although this pricing structure within OPEC was not always successful as it caused price splits from time to time, OPEC continued to focus on setting the price of the Marker Crude until 1982, allowing production levels to be determined by the market.

It is generally accepted that Saudi Arabia could be described as the "dove" within OPEC as far as setting oil prices is concerned. Its moderate position on oil prices stems naturally from the characteristics of the Saudi oil industry, which has enormous production capacity and proven reserves. From the Saudi perspective, high oil prices serve to encourage the development of alternative energy sources, the improvement of energy efficiency, and the increasing market share of non-OPEC countries that have

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[45] Kyle L. Pakka, ed. *The Energy within a Photo History of the People of Saudi Aramco* (Dahran, Saudi Arabia: Saudi Arabian Oil Company, 2006), 81.

[46] McHale, *Saudi Oil Policy*, 4.

[47] Ian Skeet, *OPEC: Twenty-Five Years of Prices and Politics* (Cambridge: Cambridge University Press, 1988), 102.

relatively high production costs. All these developments could severely undermine not only current Saudi economic interests by reducing its own oil output, but also future economic prosperity by making the value of Saudi oil, which has a relatively long life span in comparison with other producing countries, useless or depreciate in the long run. In this regard, the country has generally pursued moderate policies on prices within OPEC by threatening other OPEC members with using the spare production capacity of Saudi oil.

This flexibility of output level based on its own excess capacity has contributed to the stability of oil prices, allowing the Saudi government to play the role of the major "swing producer" in the feeble world oil market during the short-term. The possibility of using excess production capacity by Saudi Arabia has generally prevented other OPEC producers from overpricing their oil. When Saudi Arabia failed to unify oil prices at the Doha Conference in December 1976, Saudi officials tried to keep prices at a relatively low level by threatening other OPEC members with its own spare production capacity. During most of the second half of the 1970s, Saudi efforts to moderate oil prices resulted in relatively low prices. However, in the late 1970s and the early 1980s, the bargaining power of Saudi Arabia vis-à-vis the more radical OPEC members became limited to setting relatively moderate oil prices. In addition to this unfavorable circumstance, including speculative purchases and stock-piling in the international oil market during this period, the disappearance of excess production capacity in the Saudi oil industry as a result of its greatly increased production to fill the gap caused by the Iranian Revolution and Iran-Iraq War, could not protect the world oil market from skyrocketing prices. Whether the world oil market was tight or slack, the stability of prices during the second half of the 1970s and the 1980s was largely because Saudi Arabia maintained its role of swing producer in order to stabilize oil prices. It was the only country that could prevent the market from major price fluctuations by using its excess production capacity. Because of its long-term economic interests, the Saudi government generally tried to moderate oil prices by playing the role of swing producer. Furthermore, moderate oil prices also serve for Saudi Arabia's long-term political interests, as we will see in Chapter VI. However, the deviant behavior of the Saudi government by reducing its output level in 1973 and early 1979, resulted in skyrocketing oil prices, as will be explained in Chapters VI and VII.

CHAPTER IV

SAUDI ARABIA AS A "RENTIER STATE"

The role of oil in the political and socioeconomic development of Saudi Arabia is controversial. From one point of view, oil has contributed positively to the country's development; this invaluable resource has transformed it from an outdated form of state structure based on a coalition of nomadic tribes to a modern state with a sensitive and professional bureaucracy, modern infrastructure, and the most advanced facilities for individual and public life. However, some authors reject this argument and insist that oil wealth has been the main obstacle preventing Saudi Arabia from arriving at a safe trajectory for its political, economic and social development. They particularly focus on "rentier state theory," an academic discourse concerned with the issue of the relations between rentierism and democracy. According to their explanations, rentierism has acted as one of the principal obstacles to the development of democracy in Saudi Arabia. In addition, rentierism has also encouraged the Saudis to participate in rent seeking rather than engage in productive economic activities. This has caused serious problems for the Saudi labor market, which cannot provide an adequate indigenous labor force for economic development.

Whether the outcome of oil wealth has proved negative or positive for the political and socioeconomic development of Saudi Arabia, it should be noted that this strategic natural resource has played a crucial financial role not only in establishing the modern state of Saudi Arabia but also in transforming its political and socioeconomic structure. As has been mentioned in the context of the establishment and consolidation of the kingdom in the early twentieth century, "this gloomy state of affairs continued until the Second World War, and the whole financial structure of the Saudi state might well have collapsed without the windfall from oil."[1]

The Economic Structure of a "Rentier State"

With increasing oil production in Saudi Arabia, oil price rises brought in huge government revenues, which rapidly accelerated socioeconomic transformation in a relatively short time. Saudi production increased steadily until the early 1980s (except in 1975 and 1978) since 1942, from 4,530,492 barrels in 1942 to 10,229,000 b/d in 1980, the year when it exceeded US oil production for the first time.[2] Oil prices remained relatively low until the 1960s, below $19/b at 2009 constant prices, and $2/b at current prices.[3] However, the dramatic oil price hikes in the 1970s combined with increased Saudi production gave the government unprecedented quantities of oil revenue, increasing from $10.4 million in 1946 to $333.7 million in 1960, $1,214 million in 1970, and $104.2 billion in 1980. These rapid increases were enough to dwarf the contributions of other economic sectors such as agriculture and trade. Indeed, the contribution of oil to

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[1] Sluglett and Farouk-Sluglett, "The Precarious Monarchy," 48.

[2] Anderson, *Aramco, the United States and Saudi Arabia*, 28; F. R. Parra Associates, "The International Oil Industry."See Table 3-1, 3-2, 3-3, and 3-4.

[3] British Petroleum, "BP Statistical Review of World Energy June 2010." See Oil: Crude Oil Prices since 1861.

government revenue rose from 84% in 1969 to 94.1% in 1974.[4] As the Saudi government directly receives and controls these oil revenues, particularly after the nationalization of the oil industry, the state plays the dominant role in the economy. The state became the initiator of all major economic and social development and the economic development plan relied largely on government expenditure.

When considering Saudi Arabia as a rentier state, it is useful to recall the factors that allow the state to be so defined. Hazem Beblawi outlined the characteristics of a "rentier economy" in 1987, and his definition has provided the basis of much subsequent studies. According to him, certain characteristics define the rentier state. First, the economy of the rentier state should be defined as one in which rent plays a dominant role in its economy. Second, a rentier economy should be sustained by substantial external rent. Without the existence of a strong domestic productive sector, a rentier economy based only on internal rent cannot exist. However, external rent allows the state to sustain its economy without any productive domestic sector. Third, a rentier economy only employs a few people for the generation of this rent, while the rest are only involved in its distribution or utilization. Hence only a small fraction of the population is actually engaged in the process of wealth creation. Therefore, an open economy, which relies heavily on external rent with the participation of a large proportion of the population, cannot be classified as a rentier economy. Fourth, the government of a rentier state is the major recipient of the external rent, as well as being the main actor in charge of the distribution of this wealth. In a rentier economy, those who control economic power are

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[4] Saudi Arabian Ministry of Planning, "Achievements of the Development Plans: Facts and Figures," (Riyadh: Saudi Arabian Ministry of Planning, 2006), 252; Owen and Pamuk, *A History of Middle East Economies*, 210.

able to seize political power, and it is relatively easy for them to prevent others from taking their place.[5]

There is no doubt that Saudi Arabia qualifies as a rentier state. During the 1970s, oil revenues accounted for over 85% of total government revenues, reaching a high point of 94.1% in 1974 after the oil embargo. Even in the mid-1980s when Saudi Arabia played the role of a swing producer, which caused a dramatic decline in oil revenues, from 335,236 million Saudi riyals (SR) in 1981 to 59,724 million SRs in 1986, oil revenues still accounted for over 58% of total government revenue in 1986.[6] While Beblawi does not specifically define what proportion of oil revenues accounts for total government revenues, Giacomo Luciani suggests that a rentier state should derive at least 40% of its revenues from oil or other foreign sources.[7] As the data show, Saudi Arabia meets both Luciani's requirement for a rentier state and Beblawi's initial qualification as a rentier economy.

Although the oil industry produces most of Saudi GDP and government revenue, employment in the oil industry is quite small in comparison with other sectors, amounting to less than 2% of the labor force during the second half of the 1980s. While the agricultural sector, with its minimal contribution to GDP, provided 11.4% of the total labor force in 1984, employing 515,200 people, the oil sector contributed 1.6% of the

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[5] Hazem Beblawi, "The Rentier State in the Arab World," in *The Rentier State*, ed. Hazem Beblawi and Giacomo Luciani (London: Croom Helm, 1987), 51-52.

[6] Saudi Arabian Ministry of Planning, "Achievements of the Development Plans: Facts and Figures," 251.

[7] Giacomo Luciani, "Allocation vs. Production States: A Theoretical Framework," in *The Rentier State*, ed. Hazem Beblawi and Giacomo Luciani (London: Croom Helm, 1987), 70.

total labor market, with only 71.500 employees.[8] In addition, Saudi Aramco accounted for about 96.7% of total oil production in the kingdom in 1998, while Arabian Oil Company and Getty Oil Company accounted for 3.3%.[9] As a result of the government's decision to acquire 100% of the equity of Aramco in 1976, almost all the unearned wealth from oil production in the kingdom can be at the government's disposal.

Hence, Saudi Arabia is a typical example of a rentier state, satisfying all the criteria for a rentier economy and oil revenue has had a huge impact not only on the economic structure but also on both Saudi society and politics. The economy has fluctuated considerably with the ups and downs of oil prices and production. In addition, the almost 100% acquisition of oil revenues by the state also governs the relationship between the government and population, because of government's increased role in distribution. It is hard to claim that oil is nothing more than a single natural resource in the Saudi economy. It characterizes not only the Saudi economy and society but also affects politics, particularly the development of democracy. In the next sections we will see how oil revenues have dramatically transformed the socioeconomic and political arenas.

Administrative and Socioeconomic Transformation

In the process of the consolidation of 'Abd al-'Aziz' political power, his authoritarian governing style developed out of the traditional consultative decision-making system. According to Mordechai Abir, there were two important milestones in

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[8] Saudi Arabian Ministry of Planning, "Achievements of the Development Plans: Facts and Figures," 280.

[9] OPEC, "OPEC Annual Statistical Bulletin 2002," 62.

‘Abd al-‘Aziz’ reign which affected his governing style: the collapse of the *ikhwan* rebellion in 1929/30 and the dramatic rise in revenues, first after the conquest of the Hijaz in 1925 and then with the exploitation of oil in the late 1940s. Policy decisions in Arabia were traditionally taken with the advice of the tribal elders or regional notables rather than by a unilateral decision on the part of the *shaykh*. However, this decision-making procedure was no longer viable after ‘Abd al-‘Aziz consolidated his power with the conquest of the Hijaz, which provided him with access to revenue, and the defeat of the rebellious *ikhwan*, which got rid of the last challenge to his increasingly centralist government and his relations with the British. In the 1920s, he increasingly resolved major issues by himself or consulted his unofficial *majlis al-shura* (Consultative Council), which consisted of his senior kinsmen and devoted friends. His regime after 1930 could be characterized as a paternalistic and authoritarian government.[10]

Soon after the establishment of Saudi Arabia in 1932, and faced with challenges over the succession, ‘Abd al-‘Aziz decided to monopolize power for himself and his sons. On May 11, 1933, the Royal Consultative Council, created as a proto-cabinet, issued its official *Announcement Number 3*, giving information about the procedure for the succession to the throne and the designation of Sa‘ud as ‘Abd al-‘Aziz’ successor. The ceremony of the oath of the allegiance to Sa‘ud as heir apparent was solemnized on May 22, 1933. However, the succession process did not have the full support of the Saudi family. The accession of Sa‘ud to the throne meant the complete transfer of power within the Saudi family to the ‘Abd al-‘Aziz branch as a new royal line. According to British diplomatic reports and *Umm al-Qura*, effectively the organ of the court, there was strong

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[10] Mordechai Abir, *Saudi Arabia: Government, Society, and the Gulf Crisis* (London and New York: Routledge, 1993), 27-28.

opposition to Sa‘ud’s accession from Muhammad Ibn ‘Abd al-‘Aziz, a brother of ‘Abd al-‘Aziz.[11]

Power struggles within the Saudi family ended with the victory of ‘Abd al-‘Aziz. Diplomatic reports described Muhammad and ‘Abd Allah, brothers of ‘Abd al-‘Aziz, as the major competitors for the throne in the case of Sa‘ud’s death or resignation. If the issue of succession to the throne had followed tribal precedent, the best man of their generation should have been ‘Abd al-‘Aziz’ successor. Muhammad’s contribution to the establishment of Saudi Arabia was enough to make him eligible to compete for the throne. Although the Saudi family made an alternative decision to hand over the throne to the next generation, Khalid, the eldest son of Muhammad, would also be a contender for the throne, given his seniority within the family and his personal ability. However, Muhammad’s relations with ‘Abd al-‘Aziz had deteriorated severely, almost to the point of revolt, by the middle of 1930. There are different opinions over whether Muhammad was younger than the king or not, although this did not particularly matter, since he did not challenge ‘Abd al-‘Aziz’ right to rule the newly established kingdom. Had ‘Abd al-‘Aziz died earlier, Muhammad would clearly have been a major contender for the throne since he was the senior surviving son of ‘Abd al-Rahman. Although ‘Abd al-‘Aziz tried to persuade Muhammad to pledge his loyalty to Sa‘ud, this did not work and the power struggle finally ended with the victory of the ‘Abd al-‘Aziz branch. After the death of Khalid in 1938 (he was probably assassinated) Muhammad and the rest of the opposition lost their most likely candidate for the throne. Unless ‘Abd al-‘Aziz had died earlier, thus attracting sympathy for Muhammad, there was no way in which Muhammad’s branch

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[11] Alexander Bligh, *From Prince to King: Royal Succession in the House of Saud in the Twentieth Century* (New York: New York University Press, 1984), 26-38.

could have succeeded to the throne. Defeated in the struggle for the succession, Muhammad died in 1943 and the issue was decided in favour of the sons of ‘Abd al-‘Aziz.[12]

Although ‘Abd al-‘Aziz’ evident determination to secure the succession for his sons was one of the reasons why he became more paternalistic and authoritarian, his strong leadership was not merely one of several options, but a primary requirement for the existence of his kingdom. He played a vital role in the early years of the Saudi state, given the threats to his continued rule. In addition, ‘Abd al-‘Aziz’ exercise of absolute political power was necessary for the survival of what was initially a very vulnerable political entity, which might well have disintegrated.

After solving the problem of the succession and consolidating his political power, ‘Abd al-‘Aziz was able to take charge of administrative affairs, appointing his sons to key government positions to enable them to secure their own authority. For the survival of the kingdom, a continuing supply of funds was necessary and this encouraged the establishment of diplomatic relations with the West, particularly the US, which could provide technical and financial assistance for the development of the Saudi oil industry. The increase in revenue after the discovery of oil in 1938, and constant interactions with oil companies and foreign countries eventually required the development of a more sophisticated and professional administrative structure. This apparatus was not oriented to check the power of ‘Abd al-‘Aziz, but rather used as a means of consolidating his political power by putting his sons in major governmental positions. With the development of a governmental apparatus, ‘Abd al-‘Aziz firmly secured the political

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[12] Ibid.

control of his descendants over the kingdom.

‘Abd al-‘Aziz took some time to develop a more streamlined administrative organization after the establishment of Saudi Arabia in 1932, largely because he preferred to exercise his personal power as much as possible without any interference. Although the Ministry of Finance was established in 1932, it was not until the 1950s that any clear distinction was made between the state budget and the personal fortune of the royal family. The king liked to be personally involved in all issues, from the most important to the most trivial. He governed his kingdom largely with the help of a small retinue of advisors, most of whom were foreigners,[13] and the administration remained highly personalised throughout his reign. Holden and Johns describe this unique feature of the early Saudi state:

> The King was the state because no other focus of loyalty or tribute existed beyond his person—and the ever-present threat remained that if his person should be removed or his reputation stained, the state he had created would disappear as well.[14]

Although it eventually became essential to establish a more formal administration as the country began to interact with other countries and the petroleum companies, much of the apparatus of government did not work properly. Such institutions as the Ministry of Foreign Affairs (1931), the Ministry of Finance (1932) and the Ministry of Defense (1944), all established as a result of external pressures, did not check ‘Abd al’Aziz’s personal power, and were often ignored or bypassed. Whether or not to

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[13] Peter W. Wilson and Douglas F. Graham, *Saudi Arabia: The Coming Storm* (New York: ME Sharpe, 1994), 46-47.

[14] David Holden and Richard Johns, *The House of Saud: The Rise and Rule of the Most Powerful Dynasty in the Arab World* (New York: Holt, Rinehart and Winston, 1981), 99.

make use of this small bureaucracy was left to the king's own discretion without any clear division of responsibility. In particular, the executive and fiscal offices operated largely along arbitrary lines like personal treasuries, reflecting the interests of particular princely office holders.[15]

Despite governmental inefficiency in the early years of the state, the expansion of government effectively contributed to the consolidation of political power monopolized by the 'Abd al-'Aziz branch. Ministries of Interior, Education, Agriculture, Communication, Commerce and Industry, and Health were established between 1951 and 1954. Other subordinate organizations such as the Department of Labor, the Directorates General of Petroleum and Mineral Affairs, and of Broadcasting, Press and Publications were also set up. These organizations gradually became the Ministries of Labor and Social Affairs, Petroleum and Minerals, and Information, respectively.[16] The top government posts were filled by 'Abd al-'Aziz's sons and the Saudi state succeeded in transforming itself into a dynastic monarchy. Michael Herb considers that two factors made possible this spate of princely appointments to major government posts possible:

> First, oil income paid for a radical expansion of the state, so there were new posts to fill. Second, only two classes of men had any sort of hope of claiming these offices: Ibn Sa'ud's advisers, and his sons. The advisers—foreigners virtually to a man, except Abdullah Sulayman—derived their power from their royal patron, and not from groups within Saudi society. There is no suggestion that this motley group of foreigners and personal dependents of Ibn Sa'ud ever had any hope of

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[15] Ghassan Salameh, "Political Power and the Saudi State," *MERIP Reports*, no. 91 (October, 1980): 6; Sarah Yizraeli, *The Remaking of Saudi Arabia* (Tel Aviv: Tel Aviv University, 1997), 101.

[16] Ahmed Hassan Dahlan, "The Saudi Arabian Council of Ministers: Its Environment, Its Role and Its Future," in *Politics, Administration & Development in Saudi Arabia*, ed. Ahmed Hassan Dahlan (Jeddah: Dar Al-Shorouq, 1990), 72-73.

denying Ibn Sa'ud's sons control of the government.[17]

Therefore, in the process of establishing highly sophisticated government apparatus, 'Abd al-'Aziz' sons could easily fill the major government posts without any serious opposition.

In addition to increasing external pressure to develop more sophisticated and professional organs of government, internal needs also increased in the process of the transformation of Saudi Arabia into a rentier state. The huge inflow of oil revenues into its economy and society with the rapid development of the oil industry after World War II expanded the role of the Saudi government in managing its enormous oil wealth. As the government began to dominate the economy and society through the mechanism of oil wealth distribution, many formerly independent actors such as merchants and tribal and religious leaders gradually became clients of the royal family.

The achievement of this administrative goal required the establishment of a cabinet and of an organization for fiscal and monetary management. These developments produced a unique system of checks and balances within the royal family, particularly during the reign of Sa'ud (1953–64). A rudimentary cabinet, the Council of Ministers was created in 1953, the last year of 'Abd al-'Aziz' life, while the Saudi Arabian Monetary Agency (SAMA) had been established the year before to manage the currency and fiscal policy. 'Abd al-'Aziz agreed to establish these more formal organizations partly under foreign and princely pressure, and presumably also because he realized that his appointed successor, Prince Sa'ud, was not a charismatic figure like himself who

[17] Michael Herb, *All in the Family: Absolutism, Revolution, and Democracy in the Middle Eastern Monarchies* (New York: State University of New York Press, 1999), 91.

could exercise absolute power. Towards the end of his reign these institutions provided his other sons and his advisers with the means to participate in government business. Deliberately or not, ‘Abd al-‘Aziz introduced a system of checks and balances into the royal family, as he left political room for Sa‘ud’s younger brother, Faisal, to assist him in the cabinet.[18]

The establishment of the Council of Ministers brought an entity into being that could challenge the absolute political power of King Sa‘ud. When the king was not fully in accord with the prime minister, the debate between the king and the cabinet became a crucial political issue and undermined the king’s influence on policy-making, while this separation led the cabinet to strengthen its own political power base. For most of Sa‘ud’s reign, he was not his own prime minister, which weakened his political influence. On the other hand, during the political power struggle between Sa‘ud and Faisal, the Council of Ministers was a useful instrument for Faisal to gain power. After Faisal came to the throne in 1964, the two positions were reunited and this somewhat improved the council’s ability to coordinate policy.[19] Since the accession of King Faisal, all Saudi kings have also held the post of prime minister, but although they control the Council of Ministers in this way, the efficiency of the Saudi administration is open to question.

Steffen Hertog has a somewhat negative opinion of the administrative and

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[18] Iris Glosemeyer, "Checks, Balances and Transformation in the Saudi Political System," in *Saudi Arabia in the Balance: Political Economy, Society, Foreign Affairs*, ed. Paul Aarts and Gerd Nonneman (New York: New York University Press, 2005), 216-17; Ghassan Salameh, "Political Power and the Saudi State," in *The Modern Middle East*, ed. Albert Hourani, Phillip S Khoury, and Mary C Wilson (London: Tauris, 1993), 579-600.

[19] Steffen Hertog, *Princes, Brokers, and Bureaucrats: Oil and the State in Saudi Arabia* (Ithaca: Cornell University Press, 2010), 63; Yizraeli, *The Remaking of Saudi Arabia*, 95, 103-04.

institutional efficiency of the Saudi administration as a whole, and has described the problems of the Saudi cabinet as follows:

> Although the cabinet allowed for a basic division of labor, excessive centralization often went together with a lack of coordination between different institutions. Parallel administrative structures and duplication of jurisdictions persisted. The archives are replete with references to the state's fragmentation, lamenting poor inter-Ministry coordination and conflicting personal ambitions. The distribution of responsibilities among the Ministry of Finance, SAMA, and the Central Planning Organization, for example, was unclear, and serious differences repeatedly arose among them.[20]

He regards the apparatus of the Saudi government as redundant and inefficient, producing a lack of coordination within the cabinet and unclear responsibilities and sharp confrontations among the government institutions.

Kiren Aziz Chaudhry takes a more neutral stance on the issue of whether or not these institutions were efficient or not. She focuses on the fundamental transformation of the institutions from the old to the new as follows:

> These institutional and social outcomes cannot be described as "efficient" or "inefficient" in absolute terms, for the same bureaucracy that unified the national market and created central administrative and legal institutions destroyed other forms of organization. If the new institutional arrangements were a good match for the new national business elite and the political centralizers, they were just as clearly constructed from the debris of the social and economic worlds of the tribes and the guilds.[21]

She implicitly argues that all the new institutional arrangements worked successfully for the formation of a new state, represented by a rentier state, out of the premodern socio-economic system in the Arabian Peninsula and this achievement has positive value in and of itself, regardless of the efficiency of the institutional system.

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[20] Hertog, *Princes, Brokers, and Bureaucrats*, 67.

[21] Kiren Aziz Chaudhry, *The Price of Wealth: Economies and Institutions in the Middle East* (Ithaca: Cornell Unversity Press, 1997), 139-40.

Admitting that the new institutional system in the Saudi administration matches well with a rentier state, it is difficult to excuse the inefficiency of the institutional operations of its institutions in a ceaselessly competitive world economy. As Hertog argues, the inefficiency of the Saudi bureaucracy, the so-called “spoke and hub” bureaucratic system with growth of fief-like ministries since the 1950s, has historically undermined the state’s capacity to implement economic policies such as the “Saudization” program. Rapidly growing oil wealth contributed to the creation of bureaucratic fragmentation and bureaucratic sprawl. According to Hertog, the segmented “spoke and hub” bureaucratic system places the royal family at the hub position with each major bureaucracy revolving around powerful princes as their clients. Mid- and low-level bureaucrats in every ministry also have close relations with power brokers as they establish their own formal and informal networks of brokerage for the distribution of state resources. Therefore, princes, brokers and bureaucrats are closely connected with each other through patron-client relations, and they cannot free themselves from their own obligations to the others because of internalized perceptions of obligation and honor. This unique system has basic coordination difficulties in implementing reforms or any long-term economic policies that might threaten the interests of each client, particularly since the oil boom.[22] Regime autonomy has been dramatically restricted by this bureaucratic system and it is difficult for the government to embark on the administrative changes and economic policies that it wants to implement. This tendency was clearly visible in the 1980s, and was even able to challenge the notion of Saudi oil policy as a “swing producer” implemented by the Ministry of Petroleum and Mineral Resources

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[22] Hertog, *Princes, Brokers, and Bureaucrats*.

during this period, as we will see in Chapter VIII.

The windfall of oil revenue not only contributed to the inefficiency of the Saudi bureaucratic system on a microlevel, but also had a large impact on the administrative and socioeconomic transformation of Saudi Arabia on a macrolevel. Particularly after the 1973 oil embargo, the 1970s were an important turning point in the history of the Saudi bureaucracy and the changes within it, which had a major impact on Saudi society and economy. The huge inflow of oil wealth fundamentally triggered major changes in the functioning of the Saudi bureaucracy and these unexpected changes, which redefined the main purpose of the existence of the bureaucracy as an institution, dramatically brought about new relations between state and the society.

To understand the fundamental transformations that took place within Saudi society and politics, it is important to note in what way oil revenues changed the characteristics of the Saudi bureaucracy. During the 1950s and 1960s, it was successfully equipped with extractive, regulatory, and information-gathering capacities. However, the rapid influx of oil revenues in the 1970s brought in huge resources that were sufficient to able it to dispense with taxation and customs revenues. As a result, an extractive and regulatory bureaucracy was rapidly replaced by distributive-oriented agencies, which managed the economy mainly through the distribution of the oil wealth. External rent from oil revenue accelerated dramatic changes in the institutional shape, organization, and capacities of the bureaucracy.[23]

The elimination of taxation was one of the main triggers leading to the total transformation of the Saudi bureaucracy. Before the oil boom of the 1970s, the Saudi

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[23] Chaudhry, *The Price of Wealth*, 139-43.

economy was supported not only by moderate increases in revenues from oil exports but also by direct and indirect taxes, including income taxes and various fees, and customs duties from its own population and economy. Direct taxes continued to be the largest source of income until 1955, when oil revenues overtook them. According to the first national budget in 1945-50, direct taxes in the form of *zakat* accounted for 37% of state revenues. This figure was much higher than in most less developed countries. Customs and various sales taxes also accounted for another 30%. During the 1950s and 1960s, taxes on wealth, income, and profits increased, although there was a series of reversals in effective tax collection because of the power struggle between the technocrat Prince Faisal and the populist King Sa'ud. Growing oil revenues in the late 1950s and 1960s brought a fundamental shift in taxation policies. Commercial enterprises, contractors, foreign companies, and imports became the main targets for state revenue. The collection of *zakat* and fees from nomads, farmers, and small traders and businessmen became less important and extraction from such individuals became less aggressive. As a result of the increase in imports, customs revenues became the most important source of finance for the state, and grew at a swift rate. Other indirect taxes such as road fees, municipal fees, poll taxes, stamp fees, and various charges for government services were also imposed.[24]

However, the oil boom in the 1970s had further unexpected consequences for the tax system of Saudi Arabia, since it made taxation largely redundant. The dramatic increase in oil revenues immediately encouraged the government to eliminate not only most of the taxes on nationals and fees on resident foreigners, but also virtually all indirect taxes. The elimination of most import tariffs led to the destruction of the state's

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[24] Ibid., 65, 76-77.

somewhat minimalist economic policy, which was based on a strategy of import substitution. The end of taxation also brought changes in the nature of the administrative structure. Previously, effective arms of the bureaucracy in the 1960s, such as the Department of *Zakat* and Income Tax (DZIT) and the Customs Department, rapidly shrank in size and had very limited functions, while a massive distributive bureaucracy was in the ascendant.[25] The sudden increase in revenues during the oil boom enabled the Saudi Arabia to metamorphose itself effectively into a rentier state.

After the tax-extractive function of the government was virtually abolished, a massive distributive bureaucracy reshaped society and the economy between 1973 and 1983. The expansion of the various subsidies and welfare programs initiated in the 1960s was quite remarkable. Many distributive agencies, including five development banks, were established to allocate the oil revenues throughout the domestic economy through subsidies, loans, gifts and state contracts. State employment in this distributive bureaucracy increased considerably, providing jobs for Saudi nationals. The state became central to the welfare of the population in a manner that it had not been previously. State resources directly fashioned the living conditions of the population and every individual's opportunities for employment and self-improvement.[26]

In particular, the socioeconomic transformation brought about by the oil revenues has undermined the predominant position and changed the role of traditionally influential groups in Saudi society. Tim Niblock analyzed these changes in detail in 2006, focusing on relations between the state and traditionally influential groups. According to

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[25] Ibid., 143-47.

[26] Ibid., 147-53; Tim Niblock, *Saudi Arabia: Power, Legitimacy and Survival* (London and New York: Routledge, 2006), 54.

his analysis, the Saudi state underwent an important administrative and socioeconomic transformation between 1962 and 1979. In addition to legal and administrative reforms and institutional expansion during this period, the government was now able to initiate substantial programs of planned economic and social development, which inevitably strengthened the influence of the state over society and the economy. As the Saudi government became the leading actor in economic and social development, many traditionally influential groups lost much of their social and economic basis as intermediaries between the population and the state, and became almost entirely dependent on the state. King Faisal was perhaps the individual most responsible for these developments, which continued to follow the same trajectory after his death in 1975.[27]

The expansion of the bureaucracy and the increasing role of the government in the economy and society have produced controversial results in Saudi politics. Some authors have argued that individual dependence on the state and its subsidized services, the substantial role of migrant workers in the labor market, and the massive social welfare program allowed the state to enjoy a degree of political quiescence. Thus, while the paternalistic state dramatically expanded its cooptation and distribution mechanisms based on mutual benefit, these mechanisms seem to have succeeded in making most Saudis almost entirely indifferent to politics.[28] However, as the government dominated both the economy and society, the method of the distribution of resources became crucial for the population in general, and corruption, widespread brokerage, and the mismanagement of public funds gradually produced opposition rather than the political

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[27] *Saudi Arabia*, 47-48.

[28] Hertog, *Princes, Brokers, and Bureaucrats*, 109; Niblock, *Saudi Arabia*, 54-57.

quiescence that the government intended. A good example of this was the insurrection at Mecca in 1979, which will be discussed in the next section.

Rentier State and Democracy

The relationship between the rentier state and democracy is still somewhat controversial. A major claim of rentier state theory focuses on the negative effect of rentierism on the prospects for democratization. Hossein Mahdavy first introduced the concept of the rentier state in the context of Iran in an article published in 1970.[29] However, later studies mostly focus around *The Rentier State* edited by Beblawi and Luciani in 1987, which had almost sensational repercussions within the discourse regarding the issue of democratization in a rentier state. Rentier state theory has been developed and elaborated by Lisa Anderson, Jill Crystal, Dirk Vandewalle, Michael Ross, and others, who generally agree on the basic notion that rentierism has an almost invariably negative effect on the potential development of democracy.[30]

The negative effect of rentierism on democracy in the Middle East has been studied in three main approaches. In Ross' view, these three different approaches are the "taxation effect," the "spending effect," and the "group formation effect." Ross called these three different mechanisms as a collective the "rentier effect" and argues that the

[29] Hossein Mahdavy, "The Patterns and Problems of Economic Development in Rentier States: The Case of Iran," in *Studies in the Economic Hisotry of the Middle East*, ed. Michael A. Cook (Oxford: Oxford University Press, 1970), 428-67.

[30] Lisa Anderson, "The State in the Middle East and North Africa," *Comparative Politics* 20, no. 1 (October, 1987): 1-18; Jill Crystal, *Oil and Politics in the Gulf: Rulers and Merchants in Kuwait and Qatar* (Cambridge: Cambridge University Press, 1990); Michael L. Ross, "Does Oil Hinder Democracy?," *World Politics* 53 (April, 2001): 325-61; Dirk Vandewalle, *Libya since Independence: Oil and State-Building* (London: I. B. Tauris, 1998).

rentier effect influences the shape of the regime as authoritarian or democratic. States based on a rentier economy often have authoritarian tendencies, because profits from natural resource exports displace taxes: no taxation results in political quiescence and the absence of any direct political representation for the population, since the absence of taxation supposedly nullifies the need for representation. Another reason why rentier states are unlikely to be democratic is the fact that they often buy off opposition groups and acquire public loyalty by using unearned oil revenues to reduce social pressure and dissent. In addition, rentier states lack the necessary basic preconditions for democracy, because the oil revenues are used to prevent their societies from forming independent social groups inclined to demand political participation.[31]

Taxation is a crucial variable defining the political relationship between the state and its citizens. As Lisa Anderson explains, every citizen who discharges an obligation to pay taxes has the right to demand that the state pays attention to his or her interests:

> Even more than military conscription, taxation binds the populace to the state by creating expectations among the taxpayers that they are to receive services in return for their contribution to the upkeep of the administration. As such, it creates the context for political demands of the "no taxation without representation" variety: social groups and interests demand representation in government decision-making when the state has the capacity to extract, transfer, and distribute resources within society.[32]

Taxation is a basic reason for the population to demand political participation and this holy obligation gives them the right to express their concerns.

In oil rich countries, particularly in the Middle East, oil revenues encourage states not to impose taxes on their population in order to acquire political quiescence and

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[31] Ross, "Does Oil Hinder Democracy?" 332-35.

[32] Anderson, "The State in the Middle East and North Africa," 9.

public loyalty. As a result, the state becomes virtually autonomous from society.[33] Theda Skocpol defines state autonomy as a situation where "the state formulates and pursues goals which are not simply reflective of the demands or interests of social groups, classes or society."[34] As rentier states impose virtually no taxes on their citizens, they have little interest in the citizens' political participation, and do not regard themselves as in any way obliged to facilitate it. In addition, most rentier states lack any previous history of representative government. This unorthodox system of the rentier seems to work against democracy based on the concept of "no representation without taxation".[35] In the Middle East, oil revenues supposedly provide a substitute for democracy, because the rulers in the region consider that they do not need to have representative governments since they do not tax their people.[36] According to rentier state theory, rentier states can impose limitations on political participation, and this prevents the society from becoming democratic.

Huge government expenditure in rentier states is another mechanism designed to create political acquiescence. The rentier state theory argues that the dominant economic role of governments in rentier states produces favorable political consequences for regimes, because most people can acquire economic privileges and benefits from their government in exchange for political quiescence. Governments in rentier states with large

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[33] Ibid., 10.

[34] Theda Skocpol, "Bringing the State Back In: Strategies of Analysis in Current Research," in *Bringing the State Back In*, ed. Peter B. Evans, Dietrich Rueschemeyer, and Theda Skocpol (Cambridge: Cambridge University Press, 1985), 9.

[35] Luciani, "Allocation vs. Production States," 73-76.

[36] Crystal, *Oil and Politics in the Gulf*, 6.

oil revenues and relatively small populations can easily acquire political loyalty or reduce dissent or social grievances by imposing various mechanisms of expenditures.

First, as the economic activities of the private sector are closely related to government spending, and access to capital and all kinds of licenses and permissions for business are under the control of the government, most of the population in the private sector is intimately concerned in maintaining the political stability of the regime. The government can provide politically favorable conditions for the ruling family by privileging its allies, or conversely by punishing those who oppose it.[37] As a result, the increasing role of government expenditure in the private sector leads more people to support the ruling family.

Second, rentier states have developed the ability to utilize their generous fiscal policies to promote a society hospitable to the regime. Governments supply their citizens with various services such as free or heavily subsidized education, health care, housing, and a wide range of goods and services.[38] Beblawi describes the favorable political circumstances created by the increased economic power of a rentier state as follows:

> It is important to add that the rentier nature of the new state is magnified by the tribal origins of these states. A long tribal tradition of buying loyalty and allegiance is now confirmed by an *état-providence*, distributing favors and benefits to its population.[39]

Thus, the various welfare programs provided by the rentier governments contribute to the creation of favorable political environments as they infuse loyalty and allegiance into the

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[37] F. Gregory Gause, *Oil Monarchies: Domestic and Security Challenges in the Arab Gulf States* (New York: Council on Foreign Relations Press, 1994), 43.

[38] Khaldoun Hasan Al-Naqeeb, *Society and State in the Gulf and Arab Peninsula*, trans. L. M. Kenny (London and New York: Routledge, 1990), 82-83.

[39] Beblawi, "The Rentier State," 53.

hearts of their people.

These welfare programs were expected to compensate for the limitations on political participation based on the concept of "no taxation without representation."[40] As rentier state theory argues, it is natural that this should produce a largely apolitical society. However, since it is rarely the case that a policy of no taxation can guarantee a politically favorable environment for the regime of a rentier state, such states try to provide their people with various welfare programs as an additional means of encouraging an apolitical society based on political loyalty and support for the regime.

More precisely, widely applied welfare programs do not imply that a rentier state is equal to a welfare state, and in fact the two are quite different. Chaudhry distinguishes between a welfare state, which is redistributive, and a rentier state, which is distributive. According to her explanation, it is not correct to call a rentier state a welfare state, because a rentier state as a distributor of wealth acquires its income directly from external rent, while a welfare state gains its wealth from the population through taxation and re-distributes it to its own population.[41] Therefore, it is very important to note that the mechanism of wealth distribution by a rentier state is far from equivalent to that of a welfare state.

The final mechanism of government expenditure in building favorable political circumstances is to create more jobs in the government. The increase in well-paying government positions, as a result of building up an expanded bureaucratic apparatus, creates another patron whose interests go hand-in-hand with those of the current political

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[40] Nazih Ayubi, *Overstating the Arab State: Politics and Society in the Middle East* (London: I. B. Tauris, 1995), 224-55.

[41] Chaudhry, *The Price of Wealth*, 26.

order. However, it should be noted that government spending in rentier states for the expansion of the bureaucracy is not always used in a positive way to attract political loyalty by creating more regime-oriented jobs. Oil revenues also allow these governments to reinforce their coercive apparatus to control society and to repress opposition groups.[42] In this regard, Øystein Noreng implies that the autocratic characteristics of rentier states are strengthened by oil wealth.[43]

According to rentier state theory, government expenditure is generally used to create a favorable political environment. The huge financial capacity of the rentier states allow them to have their own unique distributive economic strategy to obtain loyalty from the population in both positive and negative ways. Rentier regimes either try to buy off opposition groups and increase their patronage through the distribution of unearned income, or alternatively put opponents under economic disadvantages and repress dissent by various coercive means.

Another aspect of rentier state theory is that oil wealth also contributes to the distortion of a sound social structure, which puts fundamental limitations on the development of democracy. As Gause points out, "the nature of the rentier economy has, directly and indirectly, weakened the economic bases of groups that in the past were sources of potential opposition to the state—most notably tribes and labor organizations."[44] Jill Crystal also explains how oil revenues have affected political re-arrangements initiated by the breakdown of the traditional economic base. In particular,

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[42] Gause, *Oil Monarchies*, 43.

[43] Øystein Noreng, *Oil and Islam: Social and Economic Issues* (Chichester: John Wiley & Sons, 1997), 2-3.

[44] Gause, *Oil Monarchies*, 43.

she focuses on relations between rulers and merchants in Kuwait and Qatar, describing the evolution of their political environment as follows:

> The immediate consequence of oil revenues was the breakdown of the economic basis of the historical governing coalition—the alliance binding the rulers and the trading families—and the development of new and unstable arrangements which excluded the merchants from formal political life. Old alliances, forged in scarcity, did not hold up in an environment of abundance….. Rapidly the dependence of the rulers on the trading families withered.[45]

The new oil wealth allowed the rulers in Kuwait and Qatar to gain political independence from the old trading families.

According to Crystal's argument, the rulers in both countries tactically have injected oil wealth into the merchant community in order to acquire political quiescence while excluding them from participation in decision-making. This strategic action of the rulers has two aspects: while the trading families became economically dominant, they became marginalized in the political arena. This political outcome can be understood as one in which the merchants were bought off collectively by the state. As a result of the direct control of oil revenues by the government, money was no longer a problem, and the rulers' reliance on the merchants either decreased or was eliminated altogether. After the merchants lost their extractive capacity, the relation between the rulers and the merchants became unilateral. The merchants did not demand political participation in exchange for receiving the benefits of the oil wealth.[46]

In psychological terms, it is claimed that the rentier economy also creates a so called "rentier mentality," which makes a large proportion of the people acquire their incomes not in a productive way but as contract brokers and local partners or sponsors for

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[45] Crystal, *Oil and Politics in the Gulf*, 7.

[46] Ibid., 9-10.

foreign companies. Only a few people are involved in the production of the oil wealth, and the rest of the population relies on the government's distribution of rent.[47] As Abdel-Fadil points out, "such active rent-seeking behavior by most individuals in rentier societies affects people's perception of the working of the economic system." He argues that this rent-seeking mentality becomes self-perpetuating and creates a unique economic system.[48] This harmful mentality also discourages the formation of the social group as a class. As Crystal explains, for example, the merchants who used to be participants in the production process and have now become so called "rent-seekers," also lost the historical economic base which had united them as a class.[49]

Again, the fact that the Saudi labor market has a very large number of migrant workers is one of the major factors preventing the formation of a Saudi working class of the kind that usually leads political movements. During the oil boom period, very large numbers of foreign workers were essential for the development of the economy, because of limited indigenous human resources. Therefore, non-Saudi workers increased considerably, showing their highest rate of 35.4% annual growth between 1974 and 1979. The total number of non-Saudi workers rose from 317,000 in 1970, accounting for 20.7% of the total labor force, to 1,782,100 in 1979, accounting for 54.4% of the total labor force.[50] Although non-Saudi workers outnumbered Saudi workers in the private sector,

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[47] Beblawi, "The Rentier State," 52, 55-56.

[48] Mahmoud Abdel-Fadil, "The Macro-Behavior of Oil Rentier States in the Arab Region," ibid., 86.

[49] Crystal, *Oil and Politics in the Gulf*, 7.

[50] Saudi Arabian Ministry of Planning, "Achievements of the Development Plans: Facts and Figures," 277-78. See Table 25-4 and 25-5.

particularly manufacturing and construction, their political influence on Saudi society was negligible. They were employed by Saudi sponsors on short-term contracts without any legal protection, and most of their earnings were remitted to their home countries. Their contact with Saudi nationals was very limited as they worked in "enclave developments" far from the main towns. As migrant labor forces composed the majority of the manual labor force and Saudi manual workers enjoyed relatively higher wages and better working conditions, it has been impossible for the Saudi labor force, normally one of the major social bases for political movements, to establish itself as a strong social group which could open the sphere of political participation and collective bargaining activities.[51]

Although a lot of writing on rentier state theory tries to prove the adequacy of the concept and even to expand its realm, even claiming correlations between oil prices and instances of violent opposition such as civil war and uprisings,[52] the validity of rentier state theory is still in question. In 2001, Ross's quantitative study proved statistically the "oil impedes democracy" claim by using time-series cross-national data from 113 states between 1971 and 1997.[53] However, this notion of "oil prevents democracy" is still challenged, and does not receive universal support. Some skeptics such as John Waterbury, Gwenn Okruhlik, and Michael Herb still refute rentier state theory with their case studies and theoretical pieces. Of course, the demand for democratization in the

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[51] Niblock, *Saudi Arabia*, 55.

[52] Christopher Lotz, "Rentierism and Repression," *Journal of Politics & International Affairs* (Spring, 2008): 106-19.

[53] Ross, "Does Oil Hinder Democracy?" 325-61.

Middle East does not arise from tax burdens.[54] Moataz Fattah indicated that in the long-term the rentier economy, which brings about high rates of unemployment, increased government spending, and a heightened expectation on part of the population that massive welfare handouts will "always" be available from the government; all of which has eventually had harmful effects on the legitimacy of the rulers in rentier states.[55] For Saudi Arabia, Gwenn Okruhlik argues that there is no necessary link between the accumulation of wealth and particular social outcomes, as oil states often bring their own civil opposition into being by, for example, their dictatorial behavior.[56] Michael Herb also finds that there is no evidence to prove that rentierism constrains democracy. He has a somewhat neutral position on the effects of rentierism; he sees the oil wealth as neither a curse nor a blessing for democracy, and even suggests that rentierism has positive as well as negative effects on the development of democracy. He suggests that regional factors such as Islam should also be part of explanations of authoritarian regimes in the Middle East.[57] Robin Wright shares Herb's opinion about the negative effect of "Islam" on democracy: "In Saudi Arabia, Islam's tenets have been selectively shaped to sustain

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[54] John Waterbury, "Democracy without Democrats?: The Potential for Political Liberalization in the Middle East," in *Democracy without Democrats?: The Renewal of Politics in the Muslim World*, ed. Ghassan Salamé (London: I. B. Tauris, 1994), 29-30.

[55] Moataz A. Fattah, *Democratic Values in the Muslim World* (Boulder: Lynne Rienner Publishers, 2006), 137-38.

[56] Gwenn Okruhlik, "Rentier Wealth, Unruly Law, and the Rise of Opposition: The Political Economy of Oil States," *Comparative Politics* 31, no. 3 (April, 1999): 295-315.

[57] Michael Herb, "No Representation without Taxation?: Rents, Development and Democracy," ibid. 37 (April, 2005): 297-317.

an authoritarian monarchy."[58]

For proponents of rentier state theory, it seems clear that the structure of the Saudi economy, represented as a rentier economy, has contributed to the obstruction of democratization. The logic of rentier state theory states that oil revenues have promoted administrative and socioeconomic transformation in Saudi Arabia and these changes have brought about new political arrangements. Many argue that the inflow of huge oil wealth, particularly after the oil boom of the 1970s, produced a rentier economic structure in Saudi Arabia and the increasing role of the government in its economy re-defined the relations between the state and the population. As the government has full control of the oil wealth and most of the population depends on oil revenues for its economic activities, the Āl Saʻud could easily establish an undemocratic and authoritarian regime through various distributive strategies.

It seems plausible to apply rentier theory to Saudi Arabia, although there is no clear evidence to prove the correlation between the absence of democracy and the rentier economy. As Okruhlik argues, in the country's history, civil opposition and disaffection began to be expressed more frequently *after* Saudi Arabia became qualified for rentierism, particularly as the government owns and manages the major oil companies. The windfall of financial and economic profits from the export of petroleum caused social dissatisfaction and newly reinforced social identities with regard to the distribution and mismanagement of the oil wealth.[59] As Terry Lynn Karl argues, corruption and the

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[58] Robin Wright, "Two Visions of Reformation," in *Islam and Democracy in the Middle East*, ed. Larry Diamond, Marc F. Plattner, and Daniel Brumberg (Baltimore: The Johns Hopkins University Press, 2003), 221.

[59] Okruhlik, "Rentier Wealth," 295-315.

profligate spending of oil revenue are regular ingredients of a rentier state economy.[60] These negative effects of the rentier state economy are sometimes serious enough to provoke the political awareness of the general population to challenge the regime. Saudi Arabia was not also historically free from these negative effects caused by a rentier state economy.

Oil revenue abuse by the Saudi royal family from time to time provoked political awareness of societal corruption rather than popular acquiescence via the mechanisms of oil wealth distribution. Huge increases in government expenditure and the corrupt involvement of politically powerful princes in oil wealth have attracted special attention. The insurrection at Mecca in 1979, admittedly now some thirty-five years ago, was a good example of the expression of social grievance against a corrupt ruling class. The Meccan rebels asked Saudis to withdraw their loyalty from the royal family by mentioning corruption, bribery and the wasting of the nation's money as one of their main reasons for their insurrection. This incident suggests that some part of the population had become less tolerant of the informal and inequitable use of the oil rent and this unorthodox business practice was regarded as the outflow of national wealth.[61]

According to Daryl Champion, the timing of the Mecca insurrection was also highly significant. During the oil boom, which allowed most of the population to enjoy the benefits of an unexpected increase in oil wealth, the extravagant lifestyle of the royal family and the regime's mismanagement of the national wealth was not ignored but

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[60] Terry Lynn Karl, "The Perils of the Petro-State: Reflection on the Paradox of Plenty," *Journal of International Affairs* 53, no. 1 (Fall, 1999): 31-48.

[61] Middle East Research and Information Project, "Saudi Opposition Group Lists Insurgents' Demands," *Merip Reports*, no. 85 (February, 1980): 16; Stork, "Saudi Arabia and the US," 27.

noticed by the population. Even after the execution of the Mecca insurgents, criticism of regime favoritism and corruption continued to accompany requests for political reform in the 1990s.[62] Therefore, it is hard to exactly apply rentier state theory to the case of Saudi Arabia and the notion that "rentierism prevents democracy" is not proven by the historical facts. On the other hand, it is quite clear that the distribution of oil wealth from external rent does not guarantee political quiescence, and that principled opposition to the regime cannot be bought off simply by the regime's decision not to impose taxes.

Oil and Islam

Saudi Arabia is a Muslim country, whose ideology is Wahhabism, a fundamentalist branch of Islam, and enthusiastically promotes its own blend of political and cultural Islamization not only in Saudi Arabia but also throughout the Muslim world. It is clear that Saudi Arabia is strongly connected with Islam, both historically and politically, as mentioned in Chapter II. The Arabian Peninsula is the birthplace of the Prophet Muhammad, and is the homeland for Muslims as it contains two of the holiest sites in Islam: Mecca and Medina. Because of the immeasurable religious significance of the region for the Muslim world, it is natural that Saudi Arabia has gained political legitimacy as a result of the location of these shrines on its soil, although the Saudi family itself cannot (and does not) claim any particular religious legitimation through its own genealogy. The kingdom has used Wahhabism as a means of linking Saudi Arabia to Islam for the acquisition of political legitimacy, although it should be emphasized that this legitimacy was only acquired after 'Abd al-'Aziz captured the Hijaz in 1925, rather

[62] Daryl Champion, *The Paradoxical Kingdom: Saudi Arabia* (New York: Columbia University Press, 2003), 11-12.

than having existed “from time immemorial.”[63]

Oil wealth has been used for the consolidation of political legitimacy of the Āl Sa‘ud, while allowing Saudi Arabia to be at the center of Arab and Muslim politics. It has accumulated huge amounts of wealth from oil revenue, enough to influence its own society and other Muslim countries financially. This background, and the commitment of the Saudi regime to the implementation of Wahhabi doctrine both in Saudi society and as far as possible in the rest of the Muslim world, provides the Saudi ruling elite with legitimacy of a kind and gives it a leading position in the Arab and Muslim worlds.[64] In other words, since Saudi Arabia became the richest country not only in the Arab world but also in the Muslim world because of its enormous revenues from oil during the boom period, it could not escape involvement in the Arab-Palestinian and Islamic issues, and indeed sought to play an important role in Arab and Muslim politics.

In terms of the configuration of relations between the Saudi ruling family and the religious establishment, this pragmatic attitude of the *‘ulama* has gradually made them subordinate to the rulers, particularly in the political arena. Historically, the defeat of the *ikhwan* rebels was an essential first step for the Āl Sa‘ud to secure its superiority over all other religious group in the Saudi political sphere. By the time of the expansion of the bureaucracy in the 1950s and 1960s, the *‘ulama* had largely lost their political influence, while they had had secured a special role in certain areas with the support of the state. Although the bureaucracy is largely filled with secular-educated Saudis who provide the ruling class with an alternative set of political advice and administrative skills, the *‘ulama*

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[63] AbuKhalil, *The Battle for Saudi Arabia*, 50.

[64] Noreng, *Oil and Islam*, 228.

still remain highly influential, because their opinions are an important reference for the rulers. However, the religious group is structurally obedient and subordinate to the ruling class in Saudi political life.[65] Advice from the *‘ulama* on political issues, which does not have mandatory force, has generally shown a tendency to accord with the political will of the Saudi rulers, even though some political decisions have potentially threatened Islamic values and tradition.

Oil wealth has played an important role in making the Saudi ruler superior to the *‘ulama*. Like many other oil-rich countries in the Muslim world, Saudi Arabia does not seriously try to collect *zakat*, because the oil income is enough to carry out distributive justice for the benefit of the poor and disadvantaged and it makes *zakat* proceeds for charitable work unnecessary.[66] Because of oil income, the traditional role of the religious establishment in overseeing distributive justice has become reduced, while its financial dependence on the state has increased. The state not only provides the Wahhabi *‘ulama* with their income but also most of the financial resources for the operation and expansion of their religious activities both domestically and internationally. In return, they have played a pivotal role in sustaining the legitimacy of government policies.[67]

The occasionally awkward relations between the Āl Sa‘ud and the Wahhabi *‘ulama*, mainly caused by the infusion of oil wealth into the religious establishment, have enabled the *‘ulama* to divert political matters from what they hoped remain a largely

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[65] Gause, *Oil Monarchies*, 13.

[66] M. Raquibuz Zaman, "Boundaries and Distributive Justice: Islamic Perspective on Territorial Boundaries and Autonomy," in *Islamic Political Ethics: Civil Society, Pluralism, and Conflict*, ed. Sohail H. Hashmi (Princeton: Princeton University Press, 2002), 86.

[67] Niblock, *Saudi Arabia*, 14.

religiously oriented society. While the *'ulama* maintain considerable influence in certain areas, particularly education and justice, they have become largely marginalized from any meaningful participation in financial and economic affairs of the state and in its foreign policy. As a trade-off for the subordination of the religious group to the state, the government has allowed the religious institution to have extensive powers in certain areas in exchange for political loyalty and support.[68] Al-Rasheed describes this unique and uneasy relationship between the Saudi ruling family and the official *'ulama* in Saudi Arabia:

> The Saudi regime is a hybrid formation that subjects religion to political will. It is neither fully secular nor religious. It is a pragmatic entity that has survived as a result of the strength of the power of oil and mystification, both internal and external. It is best described as a post-modern pastiche. The gap between the social sphere controlled by religious scholars and the political sphere controlled by royalty is responsible for serious contradictions experienced at the level of the individual and society.[69]

In contrast with the considerable influence of the *'ulama* on Saudi society, their very limited role in the political arena has produced both positive and negative effects for the historical legitimacy of the ruling family.

Although rapid modernization in Saudi Arabia after the 1970s exacerbated serious contradictions between the social and political spheres, the *'ulama* usually stood on the side of the ruling family in any situation of conflict. As Lambton remarks following Ibn Taymiyya, "A rupture of public peace (*fitna*) is one of the least forgivable of sins. Innovators are to be put down not because they are apostates but because they

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[68] Gause, *Oil Monarchies*, 16.

[69] Al-Rasheed, *Contesting the Saudi State*, 58.

threaten public order."[70] Therefore, the introduction of modern technical innovations from the West has often been countered with strong objections from religious conservatives. However, the pragmatism of the *'ulama* has almost always resulted in compromise with the political will of the ruler without seriously challenging his authority.

Since the discovery of oil in 1938, oil revenues have enabled the state to pursue a vast modernization program and this innovative development, sometimes in conflict with Islamic values and tradition, has been successfully implemented in Saudi society mostly with the approval of the Wahhabi *'ulama*. Every change in individual and social life required the consent of the religious authorities to preserve core religious values in the Saudi society. Without their consent, there could be no major changes. Their influence over Saudi society as a whole could not be ignored, even by the king. Naturally, the king preferred to persuade them rather than to impose a veto, which would show him overruling the religious authorities. There are many examples of this in Saudi history. The introduction of the telephone in the kingdom initially faced opposition from the religious authorities, but after they were persuaded of its benefits, they eventually gave it their approval, and Faisal's introduction of television as a part of his modernization programs was facilitated by the *'ulama's* understanding of its advantages for the teaching and practice of Islam.[71]

Although the consent of the *'ulama* is essential for the transfer of political power

[70] Lambton, "Law and the State," 416.

[71] Joseph A. Kechichian, "The Role of the Ulama in the Politics of an Islamic State: The Case of Saudi Arabia," *International Journal of Middle East Studies* 18, no. 1 (February, 1986): 57.

within the ruling family, even in political conflicts, they have not played any crucial role in this respect. When Sa'ud was deposed and was succeeded by his brother Faisal in 1964, this was approved in a document signed by four descendants of Muhammad Ibn 'Abd al-Wahhab, in which they justified their decision on the grounds that it was necessary to prevent chaos and civil strife. They believed that Sa'ud had caused so much social and political instability that he could no longer carry on the affairs of state. The transfer of political leadership could be justified under Islamic law in terms of the preservation of public security.[72] However, as Alexander Bligh mentioned, "until Faisal took over in 1964, the *'ulama* did not voice any opinion concerning the course of Saudi politics."[73] Bligh suggests that the *'ulama* have a tendency to side with a clear winner at the end of any political conflict, while taking an ambiguous and neutral position while the conflict is actually going on. In 1964, they participated in the final decision to dethrone Sa'ud, but their role was confined to reaffirming the decision already taken by the princes. Therefore, the impression given by various Western reports that the *'ulama* played an important role in the political crisis of 1964 is inaccurate;[74] "with their diminishing influence and shrinking numbers, the *'ulama* were no more than a rubber stamp for the Saudi princes' decisions."[75] In general, the religious establishment has not played a decisive role in politics, but has only provided the winner with political

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[72] William Ochsenwald, "Saudi Arabia and the Islamic Revival," ibid.13, no. 3 (August, 1981): 274.

[73] Alexander Bligh, "The Saudi Religious Elite (Ulama) as Participant in the Political System of the Kingdom," ibid.17, no. 1 (February, 1985): 41.

[74] Ibid., 46-47.

[75] Ibid., 47.

legitimacy by issuing a *fatwa*.

In spite of its role in ensuring the consolidation *of political power through financial* support for the religious establishment, the oil windfall has also had negative effects on the political legitimacy of the Āl Sa‘ud, while *simultaneously* undermining the authority of the Wahhabi *‘ulama*. With no great expenditure of effort, the ruling class has been able to accumulate wealth in easy ways and enjoy the benefit of oil rent. The ruling class, including the royal family, has enjoyed an extravagant, and often corrupt, life style, as oil revenues are largely at their disposal without any serious check from the religious authorities. As the *‘ulama* should fulfill their obligation to direct the behavior of their *amir* in accordance with Islamic values and traditions by providing them with good advice, the *‘ulama* also cannot avoid criticism of their indifferent attitude towards their rulers' misbehavior.

While oil wealth has brought more opportunities for the Saudi royal family to expand its influence on economic activities, the business practices of its own members have generally involved corruption. The increased business participation of the royal family and their unfair competition with "commoner" businessmen has allowed the royal family to secure its economic privileges. The payment of commissions is prevalent, particularly in construction and infrastructure projects and in arms purchases, and such a business environment almost inevitably entails corruption. The payment of commissions for securing business contracts is regarded as corruption not only in the West but is also against Islamic principles. Most Western businessmen are willing to pay 5% commission or a little bit higher in business practice in Saudi Arabia, because this may help in securing a major contract.[76] Some sources say a 30% commission is normal practice for military contracts in Saudi Arabia. As Saudi Arabia usually spends one-third of its budget on military expenditure, 10% of the budget goes into private purses, which is of course an enormous waste of the nation's oil wealth.[77] Even foreign businessmen were well aware of corruption in economic activities during the oil boom era. As one of them pointed out, "huge unnecessary construction projects are larded into the development blueprints, guaranteeing a steady flow of large capital projects that generate corrupt payments."[78]

Wide spread corruption in the Saudi government and ruling family without any serious check from the religious authorities was clearly one of main reasons that encouraged Juhayman Ibn Muhammad 'Utaybi and his followers to seize the Grand Mosque in November 1979. During the 1970s, particularly under the rule of King Faisal, Saudi society underwent a massive modernization program, undermining the power base of the *'ulama*. In this rapidly changing period, Juhayman Ibn Muhammad 'Utaybi and Muhammad Ibn 'Abd Allah al-Qahtani, who claimed to be the expected Mahdi, would have witnessed high levels of corruption in the ruling class and the deterioration of Muslim values and traditions. The insurgents claimed that the cooperation between the *'ulama* and the royal family was a primary cause of corruption, and that the *'ulama* were responsible for promoting the corruption of the royal family because of their acquiescence in such behavior. In the end, the government quelled the Mecca insurgency

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[76] John Roberts, *Visions & Mirages: Middle East in a New Era* (Edinburgh: Mainstream Publishing, 1995), 176.

[77] Noreng, *Oil and Islam*, 255.

[78] Philip Taubman, "U.S. Aids Say Corruption is Threat to Saudi Stability," *New York Times* April 16, 1980, A1, A8.

after receiving justification in a *fatwa* from the *‘ulama* on November 24, 1979.[79]

As the ruling class’ hypocritical alternation between Wahhabism and materialism was enough to raise widespread revulsion and religious guilt, it tried to cooperate with the religious establishment more closely to dilute its feelings of guilt and consolidate its political legitimacy. The Saudi royal family’s extravagant life-style period was regularly commented on in the Western media, and its reputation became tarnished. According to *The New York Times* (NYT), Foreign Minister Prince Sa‘ud al-Faisal tried to buy an 18-room apartment in New York in 1977, but his application was rejected by building residents, who feared the possibility of noisy parties and political violence.[80] NYT also reported in December 1977 that a luxurious yacht was being built in the Netherlands for King Khalid at the cost of $12 million.[81] Crown Prince Fahd also had a reputation for a dissipated and lavish lifestyle in his early life; he enjoyed gambling, spent a lot of time in casinos, and possessed huge palaces in Saudi Arabia and abroad and owned a private Boeing 747 and a $50 million yacht with luxurious decorations. He was famous for his womanizing and drinking.[82] As shown in the Western media, oil wealth introduced incongruities and paradoxes into the life of the royal family. To conceal all these negative images, the royal family had to strengthen its ties to the religious establishment.

In addition, the increasing internal and external threats from the new militant

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[79] Kechichian, "The Role of the Ulama," 58-62.

[80] Eric Pace, "Tenants Reject Apartment Sale to Saudi Prince," *New York Times* July 28, 1977, 1, B4.

[81] AP, "King Khalid to Get a $12 Million Yacht," ibid. December 20, 1977, 6.

[82] Saïd K. Aburish, *The Rise, Corruption and Coming Fall of the House of Saud* (London: Bloomsbury, 1994), 55-56; Anthony Cave Brown, *Oil, God, and Gold: The Story of Aramco and the Saudi Kings* (Boston: Houghton Mifflin Company 1999), 356.

fundamentalism against the Saudi regime also led the ruling class to embark on an implementation of religiously conservative policies during the 1980s. Both the incident in Mecca and the success of the Islamic revolution in Iran in 1979 led the ruling family to strengthen its cooperation with the religious authorities, because it needed the support of the *'ulama* against internal and external threats.[83] Fahd, who had been well known for his hedonist past and extravagant lifestyle, showed particular enthusiasm for embracing Wahhabi fundamentalism in the 1980s. To secure political support from the Wahhabi *'ulama* against internal and external threats and to revive his reputation from his past indiscretions, he tried to bolster his Wahhabi credentials by adopting more religious conservative positions.[84] As a result, society became more religiously conservative in the 1980s under the strong control of the Committee for Encouraging Virtue and Preventing Vice and its Religious Police (*Mutawwa'in*); the *'ulama* enjoyed an increased influence over society through their institutions as well. They strengthened the religious content of the educational curriculum and scrutinized the behavior of individuals in public places, strictly implementing separation of the sexes in all public places, including universities.[85]

In addition, the government embarked on a massive campaign to spread Wahhabi Islam throughout the world. This aimed to strengthen the religious image of the Saudi ruling family and thereby to enhance its somewhat tarnished political authority by minimizing internal and external challenges. The Saudi state prefers to describe this

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[83] Mordechai Abir, *Saudi Arabia in the Oil Era: Regime and Elites; Conflict and Collaboration* (Boulder: Westview Press, 1988), 28.

[84] Gerald Posner, *Secret of the Kingdom: The Inside Story of the Saudi-U.S. Connection* (New York: Random House, 2005), 102.

[85] Abir, *Saudi Arabia in the Oil Era*, 28-29.

international religious campaign within a framework of "foreign aid," rather than Islamic *Zakat*.[86] Between 1982 and 2002 alone, 1,500 mosques, 210 Islamic centers, and 2,000 schools for Muslim children were established in non-Muslim countries. Islamic charities and organizations were the most effective in spreading this campaign, and Saudi Arabia has continued its lavish endowment of these charities under King Fahd. The Muslim World League was founded under King Faisal and the Saudis donated billions to it. In addition, the royal family has contributed huge sums for *al-Haramayn,* an international charitable foundation whose stated purpose is to promote "correct belief" in the hearts of Muslims. They also donated to the International Islamic Relief Organization (IIRO) and the World Assembly of Muslim Youth (WAMY).[87]

Saudi Arabia also became deeply involved in the Afghan war against the Soviet Union in yet another effort to recover its tarnished leadership in the Muslim world. In the decade after the Soviet invasion in 1979, Saudi Arabia provided approximately $4 billion in aid to Afghan guerrilla groups, excluding grants from Islamic charities and the private funds of princes. Many Arab Muslims were recruited for the Afghan *jihad*, and it is clear that some of the largest contingents came from Saudi Arabia. The Saudis certainly encouraged their people to join the Afghan cause; Saudi Arabia's national airline gave a 75% discount for volunteers heading to Afghanistan. According to estimates from Saudi intelligence sources, as many as twenty-five thousand Saudis received training abroad

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[86] Zaman, "Boundaries and Distributive Justice," 86.

[87] Dore Gold, *Hatred's Kingdom: How Saudi Arabia Supports the New Global Terrorism* (Washington, D. C.: Regnery Publishing, 2003), 125-27.

after 1979, especially in Afghanistan.[88]

Although King Fahd encouraged the expansion of the kingdom's religious influence domestically and internationally, the development of a highly conservative society, particularly during the 1980s, did not in fact lead to a significant increase in the role of the *'ulama* in the political and economic sphere. The role of the *'ulama* was still limited to the social sphere, and they were not allowed to participate in any meaningful political decisions in foreign affairs, economic development or oil policies.[89] Religiously oriented considerations have had little influence on Saudi oil policy, as we will see in Chapter VII. Without any significant role of the religious authorities in determining crucial national issues, this highly conservative society begun to suffer psychologically from a sense of alienation from political and economic decisions in the 1990s, again challenging the political legitimacy of the Saudi regime. Particularly, many Saudis who had taken up arms in the *jihad* against the Soviet Union in Afghanistan experienced deep humiliation during the Gulf War because of the presence of American troops on Saudi soil and the almost total dependence of Saudi Arabia on the US for its security despite its huge military expenditures.[90] With increases in the coercive activities of the government and the lack of any cohesive force in society that might be able to rally opposition against the regime, Islam was the only option available to the Saudis as a means of expressing their grievances in the 1990s. In these circumstances, Stork mentioned that "the enhancement of the state and the marginalization of the opposition forces and currents

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[88] Ibid., 127-29.

[89] Abir, *Saudi Arabia in the Oil Era*, 29.

[90] Al-Rasheed, *A History of Saudi Arabia*, 163-64.

have shown up in the ascendance of religion as a political medium."[91] The unhappy political and economic situation in the 1990s has made members of a deeply religious society that is supported financially by oil wealth more open to the appeal of the rhetoric of radical Islamic fundamentalism (such as that expressed in the *Sahwa* movement) against the rule of the Āl Sa'ud.

Both oil wealth and Wahhabi doctrine not only contradict each other, but they also have shown their own paradoxical problems in preserving the legitimacy of the Āl Sa'ud. Many Saudi Muslims, particularly the Wahhabis, oppose oil wealth-driven modernization programs, which are intended to integrate their Islamically oriented society into the Western dominated world order. In addition, oil wealth and Islam, in their very nature, always have both bright and seamy sides for the political security of the Saudi ruling family. As Pascal Ménoret shows, oil wealth and Islam contribute both to the consolidation of the political power of the Āl Sa'ud, and to challenging its political legitimacy, particularly at a time when the oil wealth has not produced an especially positive outcome.

> Saudi political life appears to be the product of two causalities: one Islamic and one oil-related. In this optic the Islamic causality contradicts the oil causality, since Islam is assumed to be resistant to the West and oil extraction is the chief source of modernization and alignment with the international market…Islam is both an instrument of legitimation for the Saud family and the backdrop for opposition to its regime; while oil both drives the submission of society to the state and undermines the monarchy by placing Arabia under the economic and military domination of the United States, its main customer and supplier.[92]

Both oil and Islam are undoubtedly major factors in the sustenance of the rule of the Āl

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[91] Joe Stork, "Ten Years after," *MERIP Reports*, no. 120 (January, 1984): 5.

[92] Pascal Ménoret, *The Saudi Enigma: A History*, trans. Patrick Camiller (London: Zed Books, 2005), 71-72.

Sa‘ud, but these two pillars need be carefully maintained to ensure that they do not have negative effects on the legitimacy of the regime.

CHAPTER V

EXPLANATIONS OF WEALTH MAXIMIZATION

Oil cannot simply be regarded as one of many energy sources, either in consuming or in producing countries. It is a strategic natural resource, not only for economic development, but also for national security throughout the world. Therefore oil policies are quite complex and involve all the interested parties, both domestically and internationally. All countries that control this strategic resource have the capacity to wield considerable economic and political power worldwide. In addition, there is a general expectation that such countries will make a major contribution to the health of the world economy by providing a continuous supply of oil at economically “reasonable” prices. The policies of countries in charge of oil production and prices naturally receive a lot of international attention, particularly if they control substantial amounts of production and reserves in comparison with other producing countries. Inevitably, whether they wish to or not, the rich oil states have become profoundly involved in international politics.

It is natural that Saudi oil policy should have begun to attract significant attention from all the parties concerned with the world oil market after it took direct control of oil production and prices during the 1970s. The capacity of the Saudi oil industry, with its huge oil reserves and production levels, is and probably always will be sufficient to play a key role not only in OPEC, but also more generally on the world oil market. In addition to its huge oil reserves, its productive capacity of over 10 million b/d, which allows Saudi Arabia to increase or cut its considerable production in accordance with market situations or its own political interests, makes both producers and consumers pay close attention to its oil policies, which are likely to have a profound effect on volatile oil prices.

For an explanation of Saudi oil policy, various factors affecting the decisions of Saudi oil policy makers should be considered, either economic or political.[1] From an economic perspective, commentators have tried to find a rational strategy underlying the attempts of Saudi decision-makers to optimize the long-term value of their oil by applying various economic models. This economic school has some predictive and normative powers. However, depending on their various assumptions, the results of each economic model for wealth maximizing strategy are quite different. Even during the boom period the patterns of Saudi oil policy did not always fit these models. This economically unreliable behavior enabled alternative models, classified as nonwealth maximization, to explain Saudi oil policy, as we can see in Chapter VI (see Table 3).

Within the circle of those who seek to explain the behavior of Saudi decision-makers based on economic benefits, there are two different and contrary opinions supporting, respectively, lower levels of production at higher oil prices and higher levels of production at comparatively moderate prices. Both groups have their own plausible

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[1] In my dissertation, the economic explanation of Saudi oil policy does not include the target revenue model, because it is not a wealth-maximizing model. Some authors regard the target revenue model as one of the economic explanations for Saudi oil policy. It will be separated from the economic explanation and will be discussed as one of the minor explanations of nonwealth maximization in Chapter VI.

Table 3. Different Models to Explain Saudi Oil Policy

Classification of Models	Model	Characteristics
Wealth Maximization (high oil prices and low oil production)	Monolithic Cartel	Collusive model of the OPEC members Initial price should be high Conservationist tendency
	Property Rights	Noncollusive model of the OPEC members Lower discount rates and higher price path
Wealth Maximization (moderate oil prices and high oil production)	Different Groups	Collusive model of the OPEC members Saudi Arabia pursues lower prices to expand output substantially within OPEC
	Dominant Producer	Collusive model of OPEC members: Saudi Arabia prefers moderate prices, because higher oil prices result in the expansion of the fringe members and the restriction of its own output
Nonwealth Maximization	Target Revenue	The revenue requirements of Saudi Arabia decide the level of oil production
	Political Interpretation	Depending on political situation, the production level of Saudi Arabia varies
	Technical Problems	Technical problems were main causes of the Saudi production cuts, particularly in 1973 and 1979

explanations in accordance with their different discount rates and the expectations of the future world energy market. The first take an optimistic view of the future oil market, based on the assumption that future price increases will make oil in the ground a more profitable investment as well as avoiding the accumulation of huge financial surpluses. This would encourage Saudi Arabia to pursue higher oil prices in tandem with relatively restricted production. The second view is based on the assumption that future demand for oil will be negatively affected by lower production at higher prices. Therefore, the best strategy seems to be to keep prices moderate, and thus prevent Saudi Arabia from suffering from any lowering in oil demand.

Monolithic Cartel

There have been attempts to understand Saudi oil policy within the framework of OPEC behavior. After the oil embargo in 1973 and the price hike, some commentators tried to understand the structure of the oil market within the framework of OPEC as a cartel. During the boom period, when prices were virtually controlled by the OPEC countries and a joint oil policy was actually discussed and determined at OPEC meetings, this tendency became more popular and gave birth to various discourses and controversies regarding the profit-maximizing strategy of the cartel and the anticipated collapse of OPEC. According to the monolithic cartel model which regards OPEC as a single dominant producer on the world oil market, the role of Saudi Arabia within OPEC should be disregarded, because it is just one of the members of the cartel and needs to cooperate with other OPEC members. As a result, Saudi Arabia pursued higher prices at the same time as conserving its oil in order to maximize its own wealth as part of a broader strategy for the cartel.

In 1931, Harold Hotelling argued that owners of exhaustible resources such as oil make intertemporal decisions to choose whether to extract it at the current price or to keep it in the ground for future extraction.[2] Accordingly, the amount of the resource that can be extracted in the future is determined by the amount of resource extracted today. The owner of such nonrenewable resources should consider the expected present value of the future price in comparison with the current market price (that is, the price which the owner is paid in the market today). Hotelling investigated monopolistic mining market

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[2] Economic theories of intertemporal consumption seek to explain people's current preferences at present in relation to consumption and saving over the course of the lifetime of their exhaustible resources.

structures and concluded that the initial price should be high and production should be slowed down under monopoly circumstances. Therefore, monopolistic pricing leads to a longer-term exploitation of exhaustible assets:[3] hence, as Robert M. Solow commented, "the monopolist is the conservationist's friend."[4]

However, the theory of exhaustible resources did not reflect the reality of the oil industry during the boom. Therefore, there were some attempts to accommodate this theory to the real conditions of the world oil market, whose structure in the 1970s has been described by Stephen Salant as follows:

> The current structure of the world's oil industry bears little resemblance to the extremes assumed in the theoretical literature on exhaustible resources. There is neither a single cartel which owns all the world's oil and thus has unchecked power to set prices over time, nor is there an abundance of measureless, "Mom-and-Pop" oil extractors dotting the globe. Instead, the industry contains one cartel with more power than any other extractor; but other extractors do exist and have enough importance, collectively and perhaps individually, to restrain the full exercise of monopoly power.[5]

He concluded that the market structures of many extractive industries, including oil, are represented neither by monopoly nor by perfect competition. In his view, the world oil market consists of both competitive firms and a collusive cartel that has dominant power over the market. The cartel as a unified enterprise generally dominates the extractors in

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[3] Harold Hotelling, "The Economics of Exhaustible Resources," *Journal of Political Economy* 39, no. 2 (April, 1931): 137-75.

[4] Robert M. Solow, "The Economics of Resources or the Resources of Economics," *American Economics Review* 64, no. 2 (May, 1974): 8.

[5] Stephen W. Salant, "Exhaustible Resources and Industrial Structure: A Nash-Cournot Approach to the World Oil Market," *Journal of Political Economy* 84, no. 5 (October, 1976): 1079. This description is similar to Hotelling's view of the market structures of the extractive industries as "intermediate between monopoly and perfect competition." See Harold Hotelling, "The Economics of Exhaustible Resources," ibid.39, no. 2 (April, 1931): 171.

the market because of its relatively larger reserves and smaller costs.

By applying a Nash-Cournot approach to the structure of the world oil market, Salant considers that the cartel takes the sales path of the "competitive fringe" as given and maximizes its joint discounted revenues by choosing a price path.[6] On the other hand, competitive small firms take the price path set by the cartel as given and choose a sales path that will maximize their own profits. Under the assumption that marginal production cost is constant, the cartel continues to raise the real price at the rate of interest until the competitive fringe completes its sales of initial stock, while the cartel continues to restrict its sales to remain as the sole provider of oil after the fringe has exhausted its reserves.[7] After competitors are eliminated from the market, the cartel will increase prices less than

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[6] The Nash–Cournot equilibrium, originated by Cournot and then generalized by Nash, assumes that each player does not consider the effects of his actions on the responses of others. Therefore, the cartel does not take account of the response of the fringe to its own policies.

[7] The optimal strategy of a cartel is to make marginal revenues of the same discounted value in all periods until its sales cease. Therefore, the marginal revenue derived from the excess demand curve grows at the rate of interest until sales cease and it then grows at a smaller or equal rate. If the price rises more than the rate of interest between two periods, the competitive speculators maximize their profits by buying in the first period and selling in the next. Conversely, if the price rises less than the rate of interest in the latter period, the competitive sector will sell off all its stocks before the next period is reached. The price rises at the rate of interest as long as competitors hold stocks, and afterwards it can rise at a smaller or equal rate. A market situation in which the sales of the cartel are completed before the completion of its competitors' sales leads the cartel to change its strategy to continue its sales after the completion of competitors' sales. When the sales of the cartel are positive, its marginal revenue will be less than the price. However, when its sales are zero, its marginal revenue will be equal to the price. In this situation, in which competitors still have positive sales and the cartel has exhausted all its stocks, the marginal revenue should grow more in comparison with the period of the positive sales of the cartel. Therefore, the completion of the cartel's sales before those of its competitors is unlikely to be possible and the last supplier in the market would be the cartel.

the interest rate until it reaches the choke price.[8] In this market situation, what OPEC really considers is not the response of the fringe to its policies but the response of consumer demand to its price decisions.

As shown above, the monolithic cartel model justifies oil conservation behavior while allowing continuous price rises as a profit maximizing strategy. This monolithic cartel model regards OPEC members as a single unit for analyzing the best strategy of OPEC in order to maximize its joint profits without considering the economic and political objectives of each member. However, this seems to be an unrealistic explanation of all sovereign members' oil policies within the framework of OPEC. Although the cartel interpretation argues that Saudi Arabia as a member of OPEC cooperates with other OPEC members, there is no historical evidence to support this claim.

There were constant arguments within OPEC about the price of oil, particularly between the more radical Iran and Iraq and the more moderate Saudi Arabia after the oil embargo of 1973-74. This controversial argument over prices between the two sides became more acute as demand for OPEC oil slowly recovered. When the price freeze at $11.51 per barrel for the Marker Crude officially ended in June 1976, nine months after the OPEC meeting in September 1975, Saudi Arabia succeeded in keeping the price of Marker Crude at the same level at the 47th OPEC meeting in Bali at the end of May 1976, and this price held until the meeting in Doha in December 1976. However, the price freeze resulted in Saudi Arabia facing with condemnation and criticism from other

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[8] Salant, "Exhaustible Resources and Industrial Structure," 1079-93; Rauscher argues that the assumption of identical cost function by Salant increases the profits of the fringe with the existence of the cartel, whereas in a more general approach the effect is ambiguous and this model cannot explain price shocks. See Michael Rauscher, *OPEC and the Price of Petroleum: Theoretical Considerations and Empirical Evidence* (Berlin: Springer-Verlag, 1989), 40.

OPEC members, particularly Iraq and Iran. Thus at the Doha meeting in 1976, Iraq and its supporters in OPEC sought an increase of at least 25%, while Yamani indicated that he might accept a 5% price increase if it were to be frozen to the end of 1977. As Saudi Arabia would not even accept a compromise 10% increase, there was an agreed price split within OPEC, with the majority deciding to increase their prices by 10% on January 1, 1977 followed by a further 5% on July 1, while Saudi Arabia and the UAE decided on an increase of only 5% on January 1.[9] This historic decision of OPEC was recorded in the *Official Resolutions and Press Releases* as follows:

> Eleven countries, within the Conference, decided to increase the price of $11.51 per barrel (former price of the Marker Crude) to $12.70 per barrel as of January 1st, 1977. The price of all other crudes shall be increased by the same amount. Saudi Arabia and United Arab Emirates decided to raise their prices by five per cent only.[10]

In the history of OPEC, the different interests of the member countries in oil prices resulted in a two-tier price system being introduced at the Doha meeting in 1976.

This two-tier system continued until July 1977, when Saudi Arabia and the UAE accepted the price of $12.70 for the Marker Crude and a further 5% price increase, while other members froze their further 5% increase in July. However, soon after the price agreement among members in July 1977, there was another public disagreement at the 50th Conference in Caracas in December 1977.[11] Official OPEC Resolutions and Press Releases officially acknowledged the organization's inability to reach an agreement and briefly noted that "The Conference considered the question of a price re-adjustment, but

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[9] Skeet, *OPEC*, 129-35.

[10] OPEC, *Official Resolutions and Press Releases*, 144.

[11] Skeet, *OPEC*, 137.

the Member Countries were unable to reach a common consensus on this issue."[12]

Widespread turbulence and uncertainty in supply during the Iranian crisis in 1978-79 created a situation where spot prices were much higher than the official price. Given the situation of OPEC in the world oil market, some OPEC countries begun to apply premiums or surcharges to their official prices. During this period, OPEC could not effectively control the price of oil and there was no price discipline and management within OPEC. Saudi Arabia was the only country to adhere to the official OPEC marker price, while other members enjoyed higher prices with additional premiums and surcharges, averaging $1.80. African crudes had even more aggressive charges, as much as $4 over Marker Crude price.[13]

Given the widespread disunity within OPEC, the monolithic cartel model could not explain another dramatic price increase in 1979-80 as well. Jacques Crémer and Djavad Salehi-Isfahani pointed out the problem of applying this monolithic cartel model to the oil market particularly in the context of the price increase of 1979-80 as follows:

> The earlier simulation models argued that the 1973 price increase was in line with a cartel maximizing the present value of wealth. Once the optimal price path is chosen, the adjustments should only come as a result of changes in the variables in the optimization problem. What caused OPEC to make the drastic adjustments in 1979-80? The disruptions of Iranian and Iraqi supply cannot explain the price increase in the cartel framework. If the pre-1980 price were the profit-maximizing price, reduction in the supply of any cartel member should have been made up by increase in output of other members, as long as production capacity was available.[14]

After all, the monolithic cartel model failed to provide plausible answers for the price

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[12] OPEC, *Official Resolutions and Press Releases*, 150.

[13] Skeet, *OPEC*, 158-61.

[14] Jacques Crémer and Djavad Salehi-Isfahani, *Models of the Oil Market* (New York: Hardwood Academic Publishers, 1991), 33-34.

hike in 1979-80 after the 1973 price increase.

Unlike the argument of the monolithic cartel model, which regards OPEC as a single unit with no competition among its members and anticipates its collapse because of widespread cheating among members, most of the second half of the 1970s witnessed considerable price discord among OPEC members but not the collapse of the organization. For most of the 1970s and early 1980s, Saudi Arabia tried to establish its own target price within OPEC, and it pursued moderate prices vis-à-vis other OPEC members rather than cooperating with them. From an economic perspective, it is natural that Saudi Arabia should pursue lower prices than other OPEC countries such as Algeria, Iran and Iraq, because its larger reserves make it more in its economic interests to have a lower discount rate. These events clearly show the defects of the monolithic cartel model as an explanation for Saudi oil policy, and suggest other economic theories will better elucidate the behavior of Saudi oil decision makers.

Property Rights

One way of overcoming the limitations of the monolithic cartel model is to apply the concept of property rights to the behaviors of each OPEC member. Unlike the monolithic cartel model, Saudi oil policy can then be understood in terms of its own economic interests without considering any collusive behavior on the part of OPEC. Ali Johany, a Saudi Arabian economist, introduced the property rights model as a useful tool to support the general tendency of each OPEC member to post higher oil prices without any collusive action. He tried to explain the price increase of 1973-74 by citing the transfer of ownership from international oil companies to oil producing governments, basing his claim on a model of no collusion between OPEC members. He argues that the sharp increase in oil prices after 1973 was not the outcome of collusion to raise prices on the part of OPEC but the result of an emerging price regime unilaterally dominated by the oil producing countries' intrinsic preference for lower discount rates and a higher price path instead of negotiating with oil companies with different economic interests.[15] However, after considering some of the historical facts and theoretical analysis, we can reach the conclusion that Johany is incorrect in asserting that the transfer of ownership was a major reason for the price hike in 1973-74.

Until the early 1970s, the oil producing governments, represented by OPEC members including Saudi Arabia, had much lower discount rates than the oil companies. Especially in the 1960s, oil companies operating in the Middle East understood and even considered it highly probable that the host governments might expropriate them, and consequently applied a high discount rate to their oil and depleted oil resources in the host countries at a rapid rate, producing as much oil as possible. Furthermore, escalating royalty and tax requirements from the host countries encouraged a pessimistic expectation towards future profits on the part of the oil companies. In fact, the economic interests of the host governments were focused on lower discount rates, which resulted in a general tendency to leave oil in the ground for lucrative future profits with a longer horizon for production. Thus the host governments generally produced less oil and raised prices after the transfer of ownership from the international companies during the

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[15] Ali D. Johany, "OPEC is Not a Cartel: A Property Rights Explanation of the Rise in Crude Oil Prices" (PhD diss., University of California, Santa Barbara, 1978), 107.

1970s.[16]

Although this model is a good explanation of why there was no widespread cheating to secure market share at the expense of other OPEC members in the 1970s, as might be generally anticipated by the classical cartel model, it has faced some historical and economic questioning from some authors. Morris Adelman asserts that this property rights model based on low discount theories is not persuasive, making reference to four different historical events. First, although the oil producing countries' power had grown with their gaining an increased proportion of profits during the 1950s and 1960s, no gradual production cutback or increase in prices took place during this period; on the contrary, prices fell. Secondly, as we can see from Iran and Iraq, many oil producing countries wanted higher production than the oil companies during the 1950s-70s, which runs counter to the property rights model. Third, although prices were completely under the control of the oil producing countries during 1970-71, there were no scarcities or price rises. The price rises between 1970 and 1973 were simply a reflection of collusion over higher taxes. Finally, the so-called "Oil Embargo" of 1973-74 was not a gradual tightening of production based on every oil producing country's economic interests represented by the noncollusive theory of lower discount rates, but a deliberately planned collusive maneuver with a clear political motivation.[17]

James M. Griffin and David J. Teece also pointed out the historical inadequacy of the property rights model. Like Adelman, they also countered this argument with the

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[16] Ibid.

[17] Morris A. Adelman, "OPEC as a Cartel," in *OPEC Behavior and World Oil Prices*, ed. James M. Griffin and David J. Teece (London: George Allen & Unwin, 1982), 39-40.

fact that the producing countries had wanted to expand production during the 1950s and the 1960s. In addition to pointing to that historical flaw, they also questioned the abrupt increase in oil prices during 1979-80. Although the property rights model can be used to understand the price rises during 1973-74, it does not fully explain the doubling of prices in 1979-80, because the transfer of ownership had been already occurred before the second oil crisis and there was no rational reason that would require any further reduction in the discount rate.[18]

Hence it is hard to apply the property rights model to Saudi Arabia from a historical analysis based on the data of oil production. In Saudi Arabia, the take over of control by Aramco from the American oil companies had been a gradual process. On the other hand, the price rise in 1973 happened very suddenly. In addition, during the period that the nationalization of Aramco was in progress, Saudi Arabia would have been expected to pursue a lower discount rate, which would have resulted in less production and higher prices. However, Saudi oil production increased from 7,684 thousand b/d in 1973 to 9,841 thousand b/d in 1979 (See Table 1).

More precisely, Saudi Arabia's decisions in 1979 were not in accordance with the property rights model. The external and internal volatility in Saudi Arabia caused by the Iranian Revolution in 1979 might have given it an incentive to serve its economic interests with higher discount rates. With the political and military threats from the Islamic Republic, Saudi Arabia might well have experienced a political crisis that might have threatened the existence of the Āl Saʻud as rulers of most of the Arabian Peninsula. Therefore, it was natural that Saudi Arabia should have increased its oil production in

[18] James M. Griffin and David J. Teece, "Introduction," ibid., 31.

tandem with moderate prices during this period in accordance with the property rights model because of the uncertain future of the regime. In fact, Saudi Arabia actually cut production during this crucial period. Aramco's production ranged between 10.2, and 10.5 million b/d/ in the first half of January 1979. On January 20, 1979, Saudi Arabia announced that it would cut output to a 9.5 million b/d monthly average for the first quarter. In early April 1979, it decided to cut its output further by imposing an 8.5 million b/d ceiling for the second quarter.[19] These decisions in the first half of 1979 run counter to the explanation suggested by the property rights model.

In addition to the lack of historical evidence to support this explanation, Adelman also tried to show the theoretical flaws in the property rights model. He argued that people usually believe that oil in the ground is worth more than money in the bank without any serious consideration of the optimum depletion rate. If the depletion rate is below optimal, the incremental money deposited in the bank from increased output is worth more than the incremental oil in the ground. Furthermore, if the depletion rate is more than optimal, production should be cut back, because additional money in the bank is less lucrative than additional natural resources in the ground. When discount rates rise, the optimum depletion rate goes up, because of increased production and less investment. However, the sharply increased discount rate as a result of greater future risk and a consequently higher depletion rate will bring swiftly rising marginal costs to the point where further production will lose money. Therefore, a changed discount rate causes the optimal depletion rate either to go up or go down depending on the magnitude of the

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[19] Petroleum & Energy Intelligence Weekly, "New Saudi Moves on Supply, Price Have Global Impact," *Petroleum Intelligence Weekly* XVIII, no. 6 (February 5, 1979): 5-7; "Saudis' Output Cut Doesn't Help Their Price Moderation," *Petroleum Intelligence Weekly* XVIII, no. 16 (April 16, 1979): 1.

discount rate. This means that a lower discount rate does not necessarily entail lower production. It can result in higher *or* lower production.[20]

Adelman claimed that the discount rates of oil set by Third World governments including Saudi Arabia had been at an abnormally low level in contrast to the realities in the late 1970s and the early 1980s. Although the possibility of political risk, which might bring about the overthrow of the current regimes, was considerably higher during this period, the discount rate of oil did not reflect this. In the case of Saudi Arabia, his estimates indicate that its relatively low discount rates, which did not reflect political realities at that time, were not lucrative, because they would bring in only a small amount of revenue at the end of the life span of the Saudi oil fields. Oil production in Saudi Arabia at that time was not high enough due to the low discount rates in comparison with its capacity, and this would result in higher oil production in the future. This calculation suggests that more production in the future will bring Saudi Arabia less economic benefit. As a result, he implied that the property rights model does not reflect the political reality of this period and that the widespread notion that "oil in the ground is worth more than money in the bank" and resulting in low discount rates in those days was obviously nonsense without having to resort to complex theoretical proofs.[21] The property rights model was only useful in explaining why OPEC as an oil cartel did not collapse as the monolithic cartel model anticipated. Therefore, this economic model was short-lived and attracted only a small group of supporters, failing to expand the discourse on the role of

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[20] Adelman, "OPEC as a Cartel," 40-42. See Figure 2.1. Solid Circles: optimal for given discount rate which shows relation of discount rate, investment, and optimal depletion on page 41.

[21] Ibid., 42-43.

property rights in each oil-producing country to explain the behavior of OPEC members in particular, largely because of the lack of historical and theoretical evidence for the validity of this model.

Different Groups

Another attempt to understand Saudi oil policy within the framework of OPEC was triggered by dividing OPEC members into several different interest groups. There have been several attempts to suggest elements of collusive behavior within OPEC for the model. Since its members had different interests with regard to oil prices and levels of production, OPEC did not act as a single unit or as a “real” cartel and discrepancies among members’ policies were widespread during the 1970s and early 1980s. Observers have tried to divide OPEC into different groups that act quite independently in accordance with their own financial requirements, development plans, domestic social pressures, absorptive capacities, production capacity, production costs, and the size of their oil reserves.

Esteban Hnyilicza and Robert S. Pindyck have divided OPEC into two different interest groups, the “saver countries” (Saudi Arabia, Libya, Iraq, UAE, Bahrain, Kuwait, and Qatar) and the “spender countries” (Iran, Venezuela, Indonesia, Algeria, Nigeria, and Ecuador) according to two variables: high or low immediate cash requirements and large or small proven reserves. As the saver group has the more limited domestic absorptive capacity[22] and usually has no immediate need for cash, it prefers a lower discount rate,

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[22]According to Paul Rosenstein-Rodan, absorptive capacity relates to the ability to use capital productively. See P. N. Rosenstein-Rodan, "International Aid for Underdeveloped Countries," *Review of Economics and Statistics* 43, no. 2 (May, 1961):

while the spender group prefers a higher discount rate, because of its immediate and large scale need for cash. In addition, there are differences in proven reserves within OPEC; in general, the saver countries have larger proven reserves than the spender countries.[23]

Hnyilicza and Pindyck have tried to find optimal bargaining solutions by using the theory of cooperative games developed by Nash. Using this framework, they found that the spender countries would produce in the early days of the entire life span of oil in general, while the saver countries would keep producing their oil as the last supplier to the end of the life span of oil after the exhaustion of the spender countries' oil. This different behavior between the two groups is largely due to their different discount rates. As the value of the saver countries' oil decreases less dramatically with their lower discount rate, they are better off keeping their oil in the ground, while the spender countries produce their oil first because of the high discount rate, implicitly setting a low value on future profits.[24]

Contrary to the claims of Hnyilicza and Pindyck, reality does not reflect their assumptions and does not seem to be a feasible solution for the wealth maximization of OPEC. They suggest that given a fixed market share, the solution within OPEC, is similar

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108; John Adler considers that "Absorptive capacity may then be defined as that amount of investment … that can be made at an acceptable rate of return, with the supply of co-operant factors considered as given." See John Adler, *Absorptive Capacity: The Concept and Its Determinants* (Washington, D. C.: The Brookings Institution, 1965), 5; Benjamin Higgins also suggested that limits on absorptive capacity cause a decline in the marginal productivity of new investment as the rate of investment increases. See Benjamin Higgins, *Economic Development: Developing Countries* (New York: Norton, 1968), 579.

[23] Esteban Hnyilicza and Robert S. Pindyck, "Pricing Policies for a Two-Part Exhaustible Resource Cartel: The Case of OPEC," *European Economic Review* 8, no. 2 (August, 1976): 139-54.

[24] Ibid.

to the optimal monopoly price path, which brings significant losses particularly to the spender countries and leaves OPEC members little room to maneuver on any optimal policy. However, under the assumption of fluctuating market shares, the optimal price path would depend on the relative bargaining power between the two groups. Given fluid market shares, the optimal price path pursued by one group necessarily requires considerable loss of profit for the others.

It is clearly wrong to apply the argument of Hnyilicza and Pindyck to Saudi Arabia. It would suggest that Saudi Arabia should have maintained low production levels to enable the "spender countries" to expand their output sufficiently to satisfy their financial requirements, but in fact Saudi Arabia increased its production and generally pursued moderate oil prices within OPEC during the oil boom period. The designation "saver countries" and "spender countries" was historically wrong, because Saudi Arabia, the representative of the "saver countries," usually tried to pursue higher discount rates in comparison with other OPEC members, while Iran, representing the "spender countries," preferred lower discount rates during the boom period.

By observing the behavior of OPEC members during 1973 and 1974, Paul Leo Eckbo argued that OPEC consists basically of three different homogeneous units.[25] His classification of OPEC and the characteristics of each group was quite different from that of Hnyilicza and Pindyck. He considered a number of different factors for his analysis: the bargaining ability and the economic power of the producer country, its willingness to produce below its potential to support the price level, a proxy both for the short-term

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[25] More specifically, he used data that show "end-1974 reserves," "1974 rate of depletion," "1973-74 change in rate of depletion," "1973-74 percent change in production," "1974 production over end 1974 capacity," "1974 oil income per capita," "embargo behavior," and "location."

market power of each OPEC member and for the willingness and ability to restrict current output, as well as the bargaining capacity of OPEC members from the data "1974 production over end 1974 capacity," the financial capacity of each country, the willingness of the producer countries to conform to joint political actions and the ease with which the price/production policies of OPEC members can be supervised.[26]

These three groups pursue their own different strategies to meet their financial requirements. The first group, the "hard core," consisting of Saudi Arabia, Kuwait, UAE, Qatar, and Libya, with the largest financial surpluses, the highest levels of excess capacity and the largest reserves of oil, could only expand output substantially at a lower price. The second group, the "price pushers," represented by Iran, Venezuela, and Algeria, was producing close to its potential in the mid-1970s and had a strong need for current account income. This group wanted to maintain current rates of production and preferred higher prices. The last group, the "expansionist fringe," consisting of Indonesia, Nigeria, and Iraq had smaller reserves than the core members of the cartel, and a strong desire for immediate income, but these countries were producing at a lower production-to–reserves ratio than the "price pushers." Therefore, this group preferred to get a larger share of the market without reducing prices at the expense of other OPEC members.[27]

Eckbo explained that the heterogeneity of OPEC members is basically embedded in their own anticipated market share, financial needs and production costs which lead

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[26] Paul Leo Eckbo, *The Future of World Oil* (Cambridge: Ballinger Publishing Co., 1976), 78-82.

[27] Ibid. Eckbo took an ambiguous position on the classification of Ecuador and Gabon, which could either be classified as "price pushers" or part of the "expansionist fringe" but could both be accommodated elsewhere. However, changing the classification of these two (fairly small) countries does not significantly affect the result of his analysis.

each member to advocate different optimal price paths for OPEC. When all three of the different OPEC subunits follow a monopoly strategy, the OPEC price will remain relatively high. However, under the assumption that regards the "expansionist fringe" as a price taker, the OPEC monopoly price trajectory without the "expansionist fringe" will remain somewhere between the aggregate OPEC monopoly price trajectory and the "hard core" monopoly price path. This excludes both the "expansionist fringe" and the "price pushers" as price takers from the monopoly role within OPEC. As the "hard core" itself has its own economic interest in a robust future demand for oil, its monopoly price trajectory stays at a lower level in comparison with the former two optimal monopoly trajectories. According to Eckbo, the high price of oil in the middle 1970s, which was far above the optimal OPEC monopoly price, reflected the strong influence of the price-pushers within OPEC. He suggested that the price range of oil in the future would be fairly wide, depending on the various cartel scenarios described as "price-pusher dominance," "cartel-core dominance," "OPEC without expansionist fringe," "cartel core monopoly" and so on.[28]

Noreng also tried to examine the behavior of OPEC members towards oil policy. As a result of the unequal distribution of reserves and considerable differences in population size, the behavior of OPEC members can be classified into two different groups of countries depending on their economic interests. He categorized two different groups in accordance with each country's income requirements and the flexibility of their oil production levels. The first group, consisting of Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Libya, and Venezuela requires large income and has little room to regulate its

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[28] Ibid., 88-110.

level of oil production. In contrast with the first group, the second group, consisting of Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates, requires relatively small income and has considerable flexibility in regulating its level of output.[29]

His classification of OPEC members and the characteristics of each group seem to be more realistic than those of Hnyilicza and Pindyck or Eckbo. As the oil reserves of the first group have a relatively short life span, countries in this group need to develop alternative sources of income. It is quite natural for these countries to be more interested in high oil prices, which would allow them to secure financial requirements for their economic development and industrialization programs. However, the countries in the second group, with their large oil reserves, have not always embarked on the rapid development of alternative sources of domestic income. Instead, their huge investments abroad, particularly in the Organization for Economic Co-operation and Development (OECD) countries, provide them with another source of income. Hence, their long-term economic interests are based on maintaining prices at a moderate level, because relatively higher prices would encourage consumer countries to look for alternative sources of energy and to develop more efficient technologies.[30]

In this genre of the different groups model, which sees OPEC as a cartel consisting of several different economic interest groups, the members of the cartel core[31] differ a little depending on the criteria being used. Most observers assign the Gulf

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[29] Øystein Noreng, *Oil Politics in the 1980s: Patterns of International Cooperation* (New York: McGraw-Hill, 1978), 63-68.

[30] Ibid., 69.

[31] The cartel core includes “Hnyilicza and Pindyck’s saver countries,” “Eckbo’s hard core,” and “Noreng’s second group.”

countries to this cartel core: Iraq and Libya were usually with the hardliners pursuing high oil prices, and it is therefore hard to classify these two countries as part of the cartel core. Even within the Gulf countries there were different attitudes towards oil prices during the 1970s and early 1980s. For example, the only country to follow Saudi Arabia at the December 1976 OPEC meeting was the UAE, while all the other Gulf countries pursued higher prices. The only country that stuck to the official Marker Crude price in the early 1980s was Saudi Arabia, while other OPEC members tried to get more revenue with higher prices by adding premiums and surcharges. Hence continuous collusion, the basic condition for the different groups model, was not observable during this period, even within the cartel core.

Dominant Producer

Both the monolithic cartel model and the different groups model, which acknowledge the role of OPEC as a cartel in the world oil market, were theoretically challenged by the success of OPEC without any anticipated collapse in the 1970s and the early 1980s. Admitting that OPEC functioned as a cartel, the prices of oil pursued by OPEC were higher than the prices on a competitive market. After the price hike of 1973, OPEC had not been seriously threatened by cheating among member countries until 1982, when it adopted a policy of production allocation among members in the face of decreasing demand. Although the possibility of the breakdown of OPEC was very high, with widespread cheating among OPEC members in the first half of the 1980s, this did not in fact occur. Within academic discourse, some authors have tried to understand why OPEC did not collapse as a result of the anticipated excess supply at the higher price.

Without the explanation of the likely reasons for OPEC's success during this period, the most influential academic explanation for the structure of the world oil market, which focused on the primary role of OPEC, would lose its theoretical foundations.

There was an attempt to explain the stability of the world oil market by focusing on the role of the international oil companies. There was no mechanism for production allocation within OPEC between its foundation and 1982. Some have tried to find reasons for the absence of any prorationing mechanism: thus, Adelman argued that international oil companies played an important role in maintaining the stability of OPEC by performing the output restriction of a cartel themselves. Given the oil-producing countries' inability to allocate production in accordance with their cartel agreements, OPEC entrusted the duty of production allocation within OPEC to the international oil companies, which carried out the prorationing role instead of OPEC in accordance with the market situation. He described the oil companies as "OPEC tax collectors," because the tax that OPEC imposed on them contributed to their role as price floor. The companies fixed oil prices above the cost of production to compensate for the low margins resulting from the imposition of tax. Although the status of the oil companies as producing contractors or customers had been reduced during the 1970s, they still played an important role in matching oil production to demand on the market as long as OPEC governments continued to refrain from making independent offers.[32]

John M. Blair even implicitly regarded the oil companies as key players in the

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[32] Morris A. Adelman, *The World Petroleum Market* (Baltimore: The Johns Hopkins University Press, 1972); "Is the Oil Shortage Real?: Oil Companies as OPEC Tax-Collectors," *Foreign Policy*, no. 9 (Winter, 1972-73): 69-107; "The Changing Structure of Big International Oil," in *Oil, Divestiture, and National Security*, ed. Frank N. Trager (New York: Russak & Company, 1977), 5.

world oil market for the stability of oil prices, because of their tactful control of the supply side in the 1970s. He argued that the cutback in production in 1975 was not manipulated by OPEC but was a result of the companies' own economic interests:

> The initiative for the 1975 production cutbacks came from the oil companies. Had it not been for the cutbacks, the market would have been flooded with distressed oil, OPEC would have broken down, and oil prices would have fallen sharply. That none of this occurred stems from the nature of the relationship between the companies and the countries.[33]

However, his argument seems to be based on speculation on the nature of the world oil market without any specific evidence.

The claim that the survival of OPEC depends on an external factor, the contribution of the oil companies, neglects OPEC's own role in controlling the oil market during the 1970s. With almost no historical evidence, few authors were ready to accept this argument. Ahmed El-Mokadem, David Hawdon, Colin Robinson, and Paul Stevens indicated the logical fallacy of this argument:

> While the pro-rationing was effectively carried out by the major oil companies, it is hard to accept the hypothesis that without the contribution of the majors OPEC would not have been able to survive, and maintain the level of crude prices.[34]

As is clear from the OPEC meetings in the 1970s, it was not the oil companies, but the OPEC member countries, which virtually controlled oil prices.

Mabro tried to find the major factors for the success of OPEC, introducing a new interpretation of OPEC as being manipulated by prices and taxes instead of production allocation. He argued that OPEC's major instruments for controlling the oil market were

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[33] John M. Blair, *The Control of Oil* (New York: Vintage Books, 1976), 293.

[34] A. M. El-Mokadem et al., *OPEC and the World Oil Market 1973-1983* (London: Eastlords Publishing, 1984), 58.

taxes and prices, as these were the main issues discussed in OPEC meetings.[35] However, this explanation had no theoretical basis after the introduction of production allocation within OPEC in 1982, just like the claims focusing on the role of oil companies. In addition, this new approach to OPEC also did not solve the problems of coordination, as Crémer and Salehi-Isfahani mentioned:

> The need for coordination between OPEC members is not lessened by the interpretation in terms of export tax . . . Without coordination, any single member's attempt to raise its tax rate above others will only result in reduced output and revenues. Furthermore, higher tax rates achieved by common action are unstable because of cheating in the form of lowering the tax rate. Therefore, the export taxation paradigm does not by itself provide a description of OPEC's solution to the cartel coordination problem.[36]

As an export tax could also lead OPEC members to widespread cheating, this argument still focused on problems of coordination within the cartel.

Another explanation for the problem of excess supply within OPEC has been the different absorptive capacity and production capacity among its members. While some OPEC countries with small populations and large oil reserves did not have much incentive to produce more oil because of their limited absorptive capacity, others with large populations and low reserves, and ambitious economic development plans, produced their oil at or near production capacity in the 1970s and there was no room for them to produce more. Therefore, OPEC did not have any problems with market shares and cheating during this period.[37]

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[35] Mabro, "Can OPEC Hold the Line?" 14; "OPEC after the Oil Revolution," 25-26.

[36] Crémer and Salehi-Isfahani, *Models of the Oil Market*, 37.

[37] Mabro, "Can OPEC Hold the Line?," 19; Theodore H. Moran, *Oil Prices and the Future of OPEC: The Political Economy of Tension and Stability in the Organization*

Although this claim seems plausible in the short-term, it is hard to trace its validity in the mid- and long-term. In some smaller OPEC countries like the Gulf States, no very considerable increase in production capacity is going to be required in the short term, because of relatively restricted revenue needs. On the other hand, some other OPEC members with large populations and low oil reserves cannot increase production capacity dramatically in the short-term, although they need more oil revenue. However, in the mid- and long-term, the picture should be totally different. There must be an incentive to increase production capacity in the latter countries, while the revenue needs of the former countries would dramatically increase in the mid- and long-term because of their rentier economic structure. This may well explain only why there was no excess supply immediately after the oil price rise of 1973. However, the experience of the latter part of the 1970s contradicted this claim.

Ambitious economic development plans in most OPEC countries during the 1970s required huge government expenditures in the mid- and long-term. According to a World Bank Staff Working Paper in 1981, the success of OPEC in achieving high oil prices during the 1970s raised members' uncertainty about how long this would last. Therefore, they felt a kind of urgency to use their bonanza as soon as possible for modernization and economic development. As a result, their governments encouraged all possible programs for the establishment of physical infrastructure and related agencies

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of Petroleum Exporting Countries (Washington, D. C.: Resources for the Future, 1978), 1; David J. Teece, "OPEC Behavior: An Alternative View," ed. James M. Griffin and David J. Teece (London: George Allen & Unwin, 1982), 81.

and offices.[38] From 1973 to 1980 OPEC exports to the major industrialized countries increased dramatically: OPEC exports to the EEC, Japan, and the US increased, respectively, from \$8.5, \$2.7, and \$3.6 billion in 1973 to \$51.5, \$18.5, and \$17.8 billion in 1980. However, this remarkable export performance was outshone by even more overwhelming increases in imports from those markets. Imports from the European Economic Community (ECC), Japan, and the US increased dramatically, respectively, from \$16.9, \$6.6, and \$3.9 billion in 1973 to 53.4, 56.8, and 52.1 billion in 1980.[39]

In spite of the claim that low absorptive capacity would prevent Saudi Arabia from increasing its production, the kingdom, the classic case of a country with large reserves and limited absorptive capacity, continuously increased production except for 1975 and 1978 in accordance with its increased revenue needs during the second half of the 1970s. At the end of the 1970s, Saudi Arabia was already experiencing a financial deficit. As explained earlier, it is clear that Saudi Arabia did have incentives to increase its oil production in the mid- and long-term, mainly because of its ambitious economic development plans, the inflow of huge amounts of money into the security sector and the squandering of the surpluses.

Under the assumption that OPEC is a cartel, the various explanations as to why it did not collapse during the 1970s and the early 1980s do not provide any plausible answers, particularly with its introduction of the allocation program in 1982. Unlike in the 1970s, the market situation in the 1980s increased the possibility of the collapse of

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[38] Rudolf Hablützel, *Development Prospects of the Capital-Surplus Oil Exporting Countries*, World Bank Staff Working Paper No. 483 (Washington, D. C.: The World Bank, August, 1981), 11-12.

[39] Timothy W. Luke, "Dependent Development and the Arab OPEC States," *The Journal of Politics* 45, no. 4 (November, 1983): 983-84.

OPEC because of the decrease in demand. During this period the soft market situation finally led OPEC to introduce prorationing mechanisms in 1982, regarded as a traditional cartel instrument. The introduction of production allocation among OPEC members in 1982 rendered the previous explanations, particularly focusing on the role of the international companies and taxes, completely useless.

To solve all these puzzles, new approaches, focusing on the structure of the oil market and OPEC's unique operational mechanism, gradually emerged and became popular. As shown above, the monolithic cartel model had already failed to explain Saudi Arabian oil policy. Even with the different groups model, it was clear that Saudi Arabia was the only country to try to adhere to the notion of the cartel core. After facing historically and theoretically weak points, particularly in the explanation of the cartel model that regarded OPEC as a unified dominant producer based on cooperation among its members, economists tried to apply the role of a dominant producer in the world oil market to Saudi Arabia alone. Throughout the 1970s and early 1980s, it is generally believed that Saudi Arabia, as the principal dove within OPEC tried to pursue moderate oil prices, in contrast to most other members. Because of its unique oil policy within OPEC, authors began to pay attention to its behavior within OPEC. They focused on its role as a swing producer and tried to explain the oil market and Saudi oil policy in terms of the dominant producer model, which is also a good explanation of the success of OPEC as a cartel. According to this explanation, Saudi Arabia sets the price, while other OPEC members sell their oil at whatever level they want. As Saudi Arabia supplies remaining oil demand, it plays the role of swing producer to keep up the monopoly price by adjusting its own production level in accordance with the extent of the gap between demand and supply in the world oil market.

As Griffin and Teece pointed out, this model does not seem to have any problem for the cartel itself, because oil prices depend more on Saudi decisions than on the cohesion of the cartel. This model does not necessarily require the cohesion of OPEC for maintaining the monopoly price. The only problem with this model is the selection of Saudi Arabia's best path to maximize its own wealth without giving fringe producers an incentive to expand their own production capacity; this would result in the reduction of residual demand for the dominant producer.[40]

A dominant producer generally has its economic interest in moderate oil prices with relatively high production levels. Many economists justify this policy as rational behavior to secure the long-term economic interests of a dominant producer in the market. Higher oil prices cause a reduction in the residual demand of the dominant producer and result in its decreased market share. Griffin and Teece described the best long-term strategy for the dominant producer in the world oil market as follows:

> It must adopt a lower discount rate, reducing its current price to a level at which new entry and the expansion of fringe members are discouraged ….. The case of limiting entry is particularly germane with reference to synthetic oil production from shales, tar sands, and coal liquefaction. Since these fuel sources can be likened to a backstop fuel, available in more-or-less infinitely elastic supply, a wealth-maximizing dominant producer with huge reserves would probably choose a price path below the price at which large quantities of synthetic fuels

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[40] Griffin and Teece, "Introduction," 27-28. Griffin and Teece classified models of OPEC behavior into two different categories, respectively, wealth-maximizing models and nonwealth-maximizing models. Wealth-maximizing models include the dominant producer model and the property rights model. While the former focuses on the monopolistic interpretation of OPEC behavior, the latter analyzes the competitive behavior of OPEC members. On the other hand, nonwealth-maximizing models employ target revenue models and political models as their analytical tool to explain OPEC behavior.

would be produced.[41]

In addition to the cartel model interpreting OPEC as a unified unit, the dominant producer model, focusing on the crucial role of Saudi Arabia in world oil prices and production, also regards the massive development of synthetic fuel as a major constraint that will affect the long-term pricing policies of OPEC and Saudi Arabia.

However, Adelman had some negative thoughts on the possibility of massive synthetic production acting as a major constraint in the early 1980s. To support his argument, he suggested that the data showed that total energy per unit of income had decreased from the first price jump year of 1973-74 to the first half of 1981.[42] In his opinion, this result had little do with the substitution of oil, but was largely due to lower consumption. What should really have concerned OPEC during the early 1980s in terms of long-term policy planning was the lowing of oil consumption as a result of high prices, rather than the substitution of other fuels for oil. The process of moving toward lower energy consumption against higher energy prices is generally very slow and takes some time, because it is an investment process, replacing the whole energy-using stock of capital. However, the reaction of oil prices is somewhat greater than the response for energy in general, because of the relatively minor rate of substitution of other fuel for oil. This greater demand for elasticity of oil, which results in decreased oil consumption under conditions of higher oil prices, should be primarily considered for the long-term policy of OPEC in the early 1980s; otherwise OPEC members would be making the

[41] Ibid., 28.

[42] Adelman indicated that the effects of higher prices of 1973-74 on the replacement process had been only a little more than half-way felt in 1981 and the second price increase in 1979 was just beginning to be felt in 1981.

biggest sacrifice in the context of continuing decline in energy and oil consumption per unit of product.[43]

Teece also warned about the negative effect of higher oil prices on the consumption of OPEC countries' oil. He suggested that higher prices in the late 1970s and early 1980s would bring about incentives for the conservation and development of substitutes for oil, and that this transformation of the world energy market would encourage less crude oil consumption in the long run. In particular, Saudi Arabia with the largest reserves and the highest ratio of reserves to production would be undoubtedly the most hard-hit victim of this policy, which brings about high oil prices.[44] Therefore, the best strategy for the dominant producer is to keep prices relatively moderate so as not to undermine demand for oil and to discourage the expansion on the part of fringe competitors.

Griffin and Teece argue that the dominant producer model had a historically fatal flaw during oil boom periods. According to their explanation, under the situation of high oil prices after 1973, Saudi oil production should have been a smaller fraction of total OPEC production than it was in 1973, if this model is applied solely to Saudi Arabia, while the other OPEC members should have taken advantage of the incentive to expand their production capacity with the development of new reserves as price takers until the early 1980s. In particular, it might have been expected that the market share of Saudi Arabia should have fluctuated with OPEC demand in the world oil market. If OPEC demand had declined, Saudi Arabia's market share as a "swing producer" should have

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[43] Adelman, "OPEC as a Cartel," 51-54.

[44] David J. Teece, "OPEC Behavior: An Alternative View," in Griffin, Teece, and Morris, 79-80.

shrunk. On the other hand, if OPEC demand had been increased, the Saudi market share should have risen during the oil boom period, but this did not happen. Although the period between 1973 and 1981 experienced high oil prices and declining OPEC oil demand in the world oil market, the market share of Saudi Arabia within OPEC had paradoxically increased. During this time, however, oil production in non-OPEC states had increased considerably (see Table 4). The behavior of the non-OPEC members is more similar to the behavior of the competitive fringe than that of OPEC members other than Saudi Arabia.[45]

In spite of Griffin and Teece's argument, it is hard to say that Saudi Arabia's oil policy based on its economic interests deviated completely from the dominant producer model. They overlooked the fact that OPEC failed to achieve a unified price system, particularly from 1977 to 1981. Even as the dominant producer Saudi Arabia could not set oil prices at the level it desired during this period. Although Saudi Arabia set oil prices based on its own economic interests, most OPEC members did not follow these oil prices for political reasons of their own. As they pursued higher oil prices, their production must have been reduced. At the same time, the relatively lower prices of Saudi oil resulted in increased Saudi output. Furthermore, the Iranian Revolution and the Iran-Iraq War exacerbated the decrease of the OPEC market share, allowing non-OPEC countries to take advantage of these events for their expansion of market share. All these political events produced the abnormal configuration of the world oil market, which cannot be exactly explained by the dominant producer model. During this period, however, Saudi Arabia generally tried to implement the logic of the dominant producer

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[45] Griffin and Teece, "*Introduction*," in Griffin, Teece, and Morris, 29.

Table 4. Saudi Arabia, Iran, Iraq, OPEC and Non-OPEC Oil Production 1973-1986. Thousand Barrels/Day (Market Share %)

	Saudi Arabia	Iran	Iraq	OPEC	Non-OPEC	World
1973	7,684 (13.1)	5,908 (10.1)	2,026 (3.5)	31,354 (53.3)	27,442 (46.7)	58,796
1974	8,603 (14.8)	6,022 (10.3)	1,971 (3.4)	30,906 (53.0)	27,382 (47.0)	58,288
1975	7,201 (13.0)	5,350 (9.7)	2,262 (4.1)	27,324 (49.3)	28,082 (50.7)	55,406
1976	8,762 (14.5)	5,918 (9.8)	2,422 (4.0)	31,192 (51.6)	29,226 (48.4)	60,418
1977	9,419 (14.8)	5,714 (9.1)	2,358 (3.8)	31,901 (50.7)	31,014 (49.3)	62,915
1978	8,544 (13.5)	5,302 (8.4)	2,574 (4.1)	30,464 (48.0)	32,968 (52.0)	63,432
1979	9,841 (14.9)	3,203 (4.9)	3,489 (5.3)	31,644 (47.9)	34,434 (52.1)	66,078
1980	10,299 (16.3)	1,490 (2.4)	2,658 (4.2)	27,676 (43.9)	35,388 (56.1)	63,064
1981	10,255 (17.2)	1,336 (2.2)	907 (1.5)	23,625 (39.6)	36,084 (60.4)	59,709
1982	6,907 (12.1)	2,412 (4.2)	1,022 (1.8)	20,119 (35.1)	37,184 (64.9)	57,303
1983	4,862 (8.6)	2,465 (4.4)	1,106 (2.0)	18,075 (32.0)	38,400 (68.0)	56,475
1984	4,434 (7.7)	2,050 (3.6)	1,231 (2.2)	17,581 (30.7)	39,746 (69.2)	57,327
1985	3,433 (6.0)	2,196 (3.9)	1,425 (2.5)	16,773 (29.4)	40,323 (70.6)	57,096
1986	5,194 (8.6)	2,073 (3.4)	1,753 (2.9)	19,759 (32.7)	40,744 (67.3)	60,503

Data Source: Table 3-3, 3-4, and 3-5 in F. R. Parra Associates, “The international Oil Industry.”

Note: Oil production data includes NGL production. Although world NGL production had increased from 5.5% of total world oil production in 1979 to 8.2% in 1986, this increase is not big enough to distort the overall trends of oil production. Like most of other oil producers, Saudi NGL production had increased similarly from 3.5% of total Saudi oil production in 1979 to 5.7% in 1986.

model into its oil policy, except for some cases, based on political exigencies.[46] Since December 1976, Saudi Arabia had pursued price freezes vis-à-vis other OPEC members, which brought a two-tier system into being for the first time in the history of the organization. In addition, while the world oil market suffered from considerable output reductions in Iran and Iraq in the early 1980s, Saudi Arabia increased its production to a maximum level to cover the supply shortfall from both countries.[47] Saudi Arabia even absorbed most of the production cuts in OPEC during the second half of the1980s, when members suffered from decreasing demand for their oil. Therefore, Saudi oil policy based on its economic interests can be generally understood within the framework of the dominant producer model.

Although many commentators have used the behavior of Saudi Arabia as a swing producer during the first half of the 1980s as their evidence for the dominant producer model, they failed to explain why Saudi Arabia tried to defend a relatively high oil price, first of around \$34/barrel and later of \$29/barrel. According to the dominant producer model, Saudi Arabia should have maintained lower oil prices during the first half of the 1980s to prevent the fringe members, particularly non-OPEC countries, from expanding their market share. Since 1976, the non-OPEC countries continuously increased their

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[46] The oil policy of Saudi Arabia in early 1979, which resulted in price rises after the decision to make production cutbacks, badly needs a political explanation. However, the general tendency of Saudi oil policy was to seek moderate oil prices unless there were political exigencies threatening the stability of the regime. The events of 1979 will be discussed in Chapter VI and VII.

[47] Although Saudi Arabia played a swing producer role by increasing its oil production considerably in the early 1980s, it continuously agreed to increase oil prices with other OPEC members in contrast with the dominant producer model. To explain why Saudi Arabia reached agreements with other OPEC members to increase oil prices continuously in this period, the basic notion of Saudi oil policy should be reconsidered. In Chapter VII, the priorities of Saudi oil policy will be discussed in detail.

market share until 1985 at the expense of organization's market share (particularly Saudi Arabia's market share). During the second half of the 1970s, high oil prices, which ranged between $45 and $50 per barrel in 2009 dollars adjusting for inflation, lowered the OPEC market share in the world from 51.6% in 1976 to 43.9% in 1980 (see Table 4). Although Saudi Arabia, facing a considerable loss of market share and a decrease in oil demand, played a swing producer role during the first half of the 1980s, it is hard to explain why it should have tried to keep relatively high oil prices in this period which resulted in further loss of market share for both Saudi Arabia and OPEC from 12.1 % and 35.1% in 1982 to 6.0 % and 29.4% in 1985 (see Table 4). The price of oil during this period, which Saudi Arabia tried to defend, was around $60 per barrel in 2009 dollars and this target price was approximately $10 higher than the prices during the second half of the 1970s, which already allowed the expansion of the fringe members (see Figure 2). Under the assumption of the dominant producer model, there is no plausible reason to explain why Saudi Arabia defended relatively high oil prices in a period during which its market share in world oil production fell by almost half (see Table 4). The behavior of Saudi Arabia as a swing producer in the 1980s explains why OPEC did not collapse even in the face of the decrease in demand for oil if we focus on the role of Saudi Arabia in OPEC as a residual supplier. However, this decision by Saudi oil policy makers did not follow the logic of the dominant producer model as an economic strategy for wealth maximization.

In addition to some theoretical limitations of the dominant producer model in explaining why Saudi Arabia tried to defend relatively high oil prices in the first half of the 1980s, the price war in 1986 triggered by Saudi Arabia's renunciation of its swing

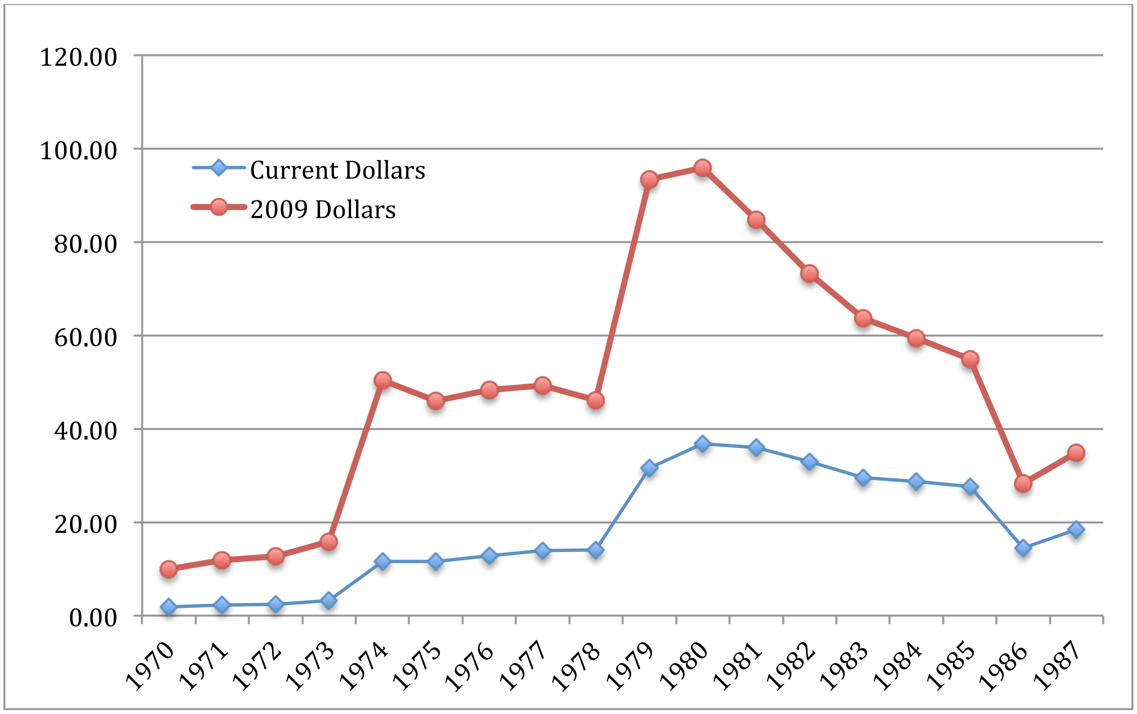

Figure 2. Crude Oil Prices 1970-1987.
(Average US $/ Barrel)

Data Source: British Petroleum, "BP Statistical Review of World Energy June 2010."

producer role in the summer of 1985 needs subordinate or alternative explanations for its oil policy. Although the dominant producer model explains well why Saudi Arabia played a swing producer role within OPEC in the slack market conditions during the first half of the 1980s, it failed to provide plausible reasons why the kingdom tried to defend relatively high oil prices and what made it suddenly give up its role as a swing producer in 1985. Hence, it may be concluded that there were other motivations for Saudi oil policy in the 1980s beyond Saudi Arabia's long-term economic interests. Although the dominant producer model gives us the theoretical tools to arrive at an understanding of the behavior of Saudi decision-makers, it has limitations in explaining Saudi oil policy in the first half of the 1980s. To answer all these questions, therefore, other explanations for an oil policy based on nonwealth maximization, particularly political explanations, will be discussed in the next chapters.

CHAPTER VI

EXPLANATIONS OF NONWEALTH MAXIMIZATION

The historical inconsistency and the theoretical limitations of economic explanations for Saudi oil policy have produced analyses that attribute at least some of the motivations of policy makers to political incentives rather than straightforward wealth maximization. Various authors, including William Quandt and David Golub, have given different weight to political explanations for Saudi oil policy. While some think political considerations are subordinate to economic explanations, since they provide plausible answers for apparently inexplicable economic behavior on the part of Saudi decision makers, others think that political considerations are the primary factor, outweighing economic explanations. The former focuses on inductive explanations for some decisions that seem to have deviated from strategies of wealth maximization. However, the latter try to provide readers with some predictive and normative rules concerning political factors affecting the behavior of Saudi oil policy makers. Although the latter has some persuasive power, it is hard to say that political factors determine Saudi oil policy because of the difficulty of distinguishing between economic and political interests in this area, particularly during normal times.

In addition to the two major explanations for Saudi oil policy (the economic and political approaches), two other minor factors should be added to the equation. From the perspective of economists focusing on target revenue theories, revenue needs are a major factor in determining production and prices. However, some argue that technical problems in the major Saudi oil fields have been crucial in deciding the level of Saudi oil production. However, it is unlikely that these two factors had a decisive role in shaping the overall policy of Saudi Arabia to the extent that they have overwhelmed economic and political explanations. In this chapter, three different explanations, based on nonwealth maximizing strategies, will be introduced, each with its own claims and empirical basis during the oil boom period.

Target Revenue

Given the limitations of economic explanations of Saudi oil policy based on the wealth-maximizing cartel models that require a degree of coordinated behavior and comprehensive collusion on the part of OPEC, there have been other attempts to explain OPEC decision-making behavior from the perspective of noncollusive forms of behavior by OPEC for oil pricing and production policy. The concept of the target revenue model has developed under the assumption that some governments have tended to decide their own oil price and production level in accordance with their own national revenue needs, in addition to considerations of internal and external political risk. Teece has described the basic mechanism of this model:

> If export receipts plus foreign earnings are such as to satisfy expenditure requirements, oil production policies will be determined by conservation considerations, where conservation involves shutting in production for future generations, even if this is not consistent with maximizing the present values of oil reserves. Conversely, if export receipts plus foreign earnings are such that expenditure requirements are not being met, production and capacity will be

expanded, so long as technical conditions permit.[1]

According to this model, expenditure requirements mainly determine production levels in the oil producing countries.

What is important in this model is the given level of a country's infrastructure, which decides the level of national expenditure requirements and the country's capacity to absorb oil revenue. The absorptive capacity of OPEC members is closely related to the capacity of the production level of each OPEC country to satisfy its own financial needs at a given price.[2] As mentioned earlier, most of the major Arab oil producing countries, particularly the Gulf States, have low absorptive capacities, which would result in a decline in the marginal productivity of new investment and inevitably in decreasing returns. According to the target revenue model, some of these OPEC countries may prefer to keep their valuable oil in the ground rather than producing more oil now to obtain revenue in excess of current needs, because they cannot absorb their revenues in domestic investment projects, and increased foreign investment is not favorable for the national economy and politics. In addition, an optimistic view of future oil prices, which supported lower discount rates, strengthened the conservative tendency of most OPEC

[1] Teece, "OPEC Behavior," 64; According to this explanation, the increase in oil price in the second half of the 1970s and the early 1980s, which brought about a huge financial surplus, resulted in the reduction of oil production. Conversely, a fall in oil prices would result in the expansion of oil production to meet budgetary requirements. This relationship between current price and current output could be best described as a short-term backward bending supply curve.

[2] Ali Ezzati, "Future OPEC Price and Production Strategies as Affected by Its Capacity to Absorb Oil Revenues," *European Economic Review* 8, no. 2 (August, 1976): 107-38.

members during the late 1970s.[3]

Basically this model sees foreign assets as an undesirable investment except for liquidity and diversification reasons, because such assets make OPEC governments vulnerable to internal and external political threats.[4] In addition, there was a widespread belief among OPEC members that foreign assets in the banks of the developed oil importing countries will generate less profits than revenues from future oil production, and large surpluses of oil revenue in the hands of OPEC members actually contribute to the economic interests of the industrialized oil importing countries, particularly the United States, rather than those of the OPEC countries. Therefore, it is more reasonable to keep as much oil as possible in the ground for future use.

This pessimistic view of increasing foreign assets was reinforced by what turned out to be largely unfounded worries about the rapid depletion of OPEC oil,[5] which had acquired considerable support among OPEC members, particularly during the late1970s. Even Ali Attiga, the Secretary-General of OAPEC, attributed the fiscal deficit of most OPEC countries during the late 1970s to the unnecessary surplus of oil revenue that had been invested in the developed world. He clearly showed his negative opinion about

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[3] El-Mokadem et al., *OPEC and the World Oil Market,* 24.

[4] According to Griffin, three critical assumptions underlay this model: (i) a fixed and slowly expanding set of investment projects; (ii) the unacceptability of foreign investments; and (iii) oil revenues are the sole source of investment funds. See James M. Griffin, "OPEC Behavior: A Test of Alternative Hypotheses," *American Economic Review* 3, no. 5 (December, 1985): 956.

[5] In the late 1970s, worries about the sharp decline in the reserve/production ratio in the Arab oil exporting countries became paramount. With some statistical data showing the rapid oil depletion rate in Arab countries, Nicolas Sarkis, director of the Paris-based Arab Petroleum Research Centre (APRC), suggested a possible reduction in oil exports to solve these worries. See Nicolas Sarkis, "The Depletion of Arab Oil Resources," *MERIP Reports*, no. 89 (July-August, 1980): 27-28.

foreign investment during an OPEC seminar in 1979:

> In spite of the fourfold increase in oil prices in 1973, and the more than tenfold increase in government share per barrel, it took only two years to make the majority of OPEC members return to the world money and capital markets as borrowers. At present, nine out of 13 members of OPEC are borrowers . . . In the mean time, the value of their investments is deteriorating rapidly due to inflation and currency fluctuations . . . Thanks to the recycling process, the so-called OPEC surplus funds are all invested in the economies of the developed oil importing countries on rather favorable terms for the borrowers, thereby reducing the real price of oil and increasing the rate of oil depletion in the oil exporting countries.[6]

In his opinion, increasing foreign investment from the OPEC surplus, implicitly caused by over-production, was not desirable for the successful economic development and the future of the oil industry in the OPEC countries.

The worries of OPEC countries about external and internal political risks as a result of their increased foreign assets were strengthened by the US freeze on Iranian assets and the increasingly negative reactions from Islamic fundamentalist groups, who seemed to agree that overproducing policies benefit only the consumers of oil. The Saudi Islamist opposition group that took over the mosque at Mecca in 1979 raised some popular demands and asked for the withdrawal of loyalty to the Saudi family for six reasons, which included a direct reference to the state's oil policy: "The Saudi family is feeding the United States and Israel with our oil and more money."[7]

Yusif Sayigh, an Arab nationalist and one of the most influential exponents of Palestinian and Arab planning and development, was also strongly opposed to overproducing in excess of national and regional needs from the Arab point of view. As

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[6] Ali Attiga, "The Impact of Energy Transition on OPEC Oil Resources: Some Problems and Prospects," *OPEC Review* II, no. 5 (December 1978): 11.

[7] Middle East Research and Information Project, "Saudi Opposition Group," 16.

he anticipated the future oil market under the optimistic assumption that the real price of oil would not drop but rather rise over the years, he recommended that the Arabs save their oil for future use in intensified industrialization. He even regarded the idea of the replacement of oil with the development of future energy technologies initiated by high oil prices as intellectual blackmail without any theoretical evidence. He implied that in the interests of the Arabs, the Arab countries, and possibly the other OPEC countries, should produce less oil to maintain high prices as long as budgetary needs are met.[8] In his opinion, the excess financial surplus in the Arab countries resulting from the overproduction of oil would not be in the political and economic interests of the Arabs. Therefore, the Arab countries should not produce oil more than their financial needs require.

According to Teece, some OPEC countries with limited absorptive capacities did not produce more oil than their financial needs during the oil boom period because of their own economic and political interests. He argued that target revenue theory applies particularly well to one particular group within OPEC represented by Saudi Arabia, Libya, Kuwait, Qatar, and the UAE. Their policies reflected their own political and economic interests. In this explanation, these countries, with higher reserve to production ratios and low absorptive capacities, could have built greater capacity expansion facilities during the late 1970s and the early 1980s. However, they did not pursue policies of competitive output expansion during this period because of their own political and economic interests. Teece argues that the widespread cheating and the consequent collapse of OPEC did not take place during the boom period because of the contribution

[8] Yusif A. Sayigh, *The Arab Economy: Past Performance & Future Prospects* (Oxford: Oxford University Press, 1982), 159.

of the low absorptive capacity of these countries to the absence of competitive output expansion.[9]

However, Teece acknowledged that Saudi Arabia was an exceptional case in the explanation of target revenue theory. He believed that Saudi Arabia was producing more oil than necessary during the 1970s and early 1980s, because its political interests were concentrated on maintaining stability in the West and in the Gulf. High oil prices would only strengthen the military capacity of the more radical producers in the Middle East and might also have caused a recession in the West. This would not only have negative effects on the Saudi economy, because of its large investments in the West, but might also bring about what was widely feared as a possible increase in communist influence in both Europe and the Middle East. Under unfavorable political circumstances, which included the Iranian Revolution, the Iran-Iraq War and the Soviet invasion of Afghanistan, the priority of Saudi oil policy at least in the short-term should be to guarantee its alliance with the West, particularly the United States. Therefore, the major motivation for Saudi Arabia to produce more than its financial requirements to prevent oil prices rising during this period was political.[10]

Although Saudi Arabia, with its limited absorptive capacity, had acquired a huge amount of income in the 1970s, its expenditure soon caught up, and it was actually in deficit in the late 1970s. Given that Saudi Arabia had dramatically increased its expenditure to keep pace with rapidly increasing oil revenues, the idea that it was producing more oil than it needed in order to maintain the political and economic stability

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[9] Teece, "OPEC Behavior," 69-73.

[10] Ibid., 79-83.

of the West was challenged in this period. Contrary to Teece's argument on Saudi oil production, Saudi Arabia produced less oil than it needed to satisfy its own expenditure in the late 1970s. Eliyahu Kanovsky refuted target revenue theory with the considerably increased Saudi budgetary requirements and the consequent financial deficit. He commented that Saudi Arabia even experienced a small deficit on its current account in fiscal years 1977-78, as the gap between revenues and expenditures closed much more rapidly than had been anticipated, mainly because of inflation (see Table 5).[11]

Despite considerably increased government expenditures in the late 1970s, resulting in deficits in 1977 and 1978, it is generally believed that Saudi Arabia produced more oil than its revenue requirements during the oil boom period. Hans Linderoth tested target revenue theory more specifically with his data covering public revenues and expenditure plus the balance of payments. He concluded that it is hard to apply this theory to Saudi Arabia, because the kingdom's supply curve did not belong to the backward bending slope except for a very short time after the first and second oil shocks.[12] During the oil boom period, Saudi Arabia continuously increased its production except in 1975 and 1978, exceeding its revenue requirements most of the time.

Target revenue theory cannot explain either Saudi Arabia's general oil policy toward over-production during the oil boom period, or the exceptional reduction of production in 1978. According to target revenue theory, it should have expanded its production level and production capacity to meet its financial needs in the late 1970s, but

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[11] Eliyahu Kanovsky, "Deficits in Saudi Arabia: Their Meaning and Possible Implications," *Middle East Contemporary Survey* 2 (1979): 318-59.

[12] Hans Linderoth, "Target Revenue Theory and Saudi Arabian Oil Policy," *Energy Policy* 20, no. 11 (November, 1992): 1078-88.

Table 5. Budgeted and Actual Revenues and Expenditures in Saudi Arabia 1969-85 (SR million)

	Revenues		Expenditures		Surplus/Deficit
	Budgeted	Actual	Budgeted	Actual	Actual
1969	5,966	5,668	5,966	N/A	N/A
1970	6,380	7,940	6,542	5,418	1,522
1971	10,782	11,120	10,782	8,303	2,817
1972	13,200	15,368	13,668	10,148	5,220
1973	22,810	41,705	22,810	18,595	23,110
1974	98,247	100,103	45,744	32,038	68,065
1975	95,847	103,384	110,934	81,784	21,600
1976	110,935	135,957	110,936	128,273	7,684
1977	146,493	130,659	111,400	138,048	-7,389
1978	130,000	131,505	130,000	147,971	-16,466
1979	160,000	211,196	160,000	188,363	22,833
1980	261,516	348,100	245,000	236,570	111,530
1981	340,000	368,006	298,000	284,650	83,356
1982	313,400	246,182	313,400	244,912	1,270
1983	225,000	206,419	260,000	230,185	-23,766
1984	214,100	171,509	260,000	216,363	-44,854
1985	200,000	133,565	260,000	184,004	-50,439

Data Source: Saudi Arabian Monetary Agency, “Forty-First Annual Report,” (Riyadh: SAMA, 2005).

did not do so. Saudi Arabia should have produced more oil in 1978 to meet its spending requirements; in fact, output decreased from 9.227 million b/d in 1977 to 8.320 million b/d in 1978 (see Table 1). Furthermore, early in 1979, Saudi Arabia decided to reduce its output level, which resulted in another skyrocketing of oil prices, and then it increased its output to its highest levels from the end of 1979 until 1981. As a result, Saudi Arabia acquired huge financial surpluses in 1979, 1980 and 1981 (see Table 4 and 5). Adelman tried to explain why Saudi Arabia could not adhere to its revenue requirements:

> There is no way of explaining the Saudi output level by "need" or by the desire to conserve oil for future use. If they produced more, they would wreck prices. So instead of installing 20 MMB/D capacity, as they once planned, they hesitate over going to 14 MMB/D.[13]

As he mentioned, it is not a simple matter to try to fix production levels to meet revenue requirements, because decisions on production levels can have unexpected effects on prices. The assumption of target revenue theory seems to be an oversimplification of the mechanisms of the world oil market without any specific consideration of the relation between price and supply. Production decisions are quite complex particularly when they derive from political considerations, as we will see in the next section.

Although target revenue theory has some merit as an explanation of why the anticipated collapse of OPEC did not happen, it has a lot of theoretical defects. As mentioned above, this theory does not really help in understanding Saudi oil policy decisions. There was no theoretical evidence at the time for the general notion that oil in the ground is a better investment than money in the bank. Furthermore, the assumption that foreign investment is less desirable in comparison with domestic investment has no theoretical underpinning or economic viability. This assumption seems to focus more on the elimination of future political risks without any economic considerations, which would presumably be designed to maximize national wealth.

In addition, the expenditures of most OPEC countries rose quickly and caught up with their income in the mid- or long-term, and the tendency to over produce made the collapse of the organization more likely. Even Saudi Arabia, the representative of those OPEC members with low absorptive capacity, had shown that its expenditures could quickly adjust to its new levels of income during the late 1970s. Target revenue theory

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[13] Adelman, "OPEC as a Cartel," 45.

has limitations both theoretically and historically in its application to the Saudi case. However, it has some implications for the future oil market as it opened the possibility of cheating and the expansion of competitive output because of increased absorptive capacity in the medium or long term. In the middle of the 1980s, this possibility became a reality, particularly under the circumstances of a soft oil market, which threatened the existence of OPEC. Teece implicitly commented on the long-term effects of rapidly increased revenue requirements on the expansion of OPEC countries' production to the extent that the existence of OPEC as a cartel might be in danger:

> The monopoly price level is not exposed to the hazards of cheating—just so long as oil revenues (plus other foreign earnings) meet budgetary needs. But once "needs" catch up with revenues, pressures to expand production will be evident . . . the stability of OPEC over the period 1974-80 need not have been the consequence of collusion. The backward bending supply curve construct implies that monopolization is possible without collusion, at least in the short run.[14]

He regards the budgetary requirements of OPEC members as one of key factors for the organization's stability.

There is no historical evidence that Saudi oil production levels rose to meet the state's revenue requirements, as target revenue theory claimed. According to Griffin's explanation of target revenue theory, "production cutbacks occur in response to rising oil prices to equate oil revenues with investment needs."[15] Thus oil prices and revenue needs in general would decisively affect the level of production, rather than the level of Saudi output determining oil prices and revenue needs. Therefore, Saudi oil policy should have been largely determined by oil prices and revenue needs, that is, its policy on production levels should have been rather passive in reaction to revenue needs and oil prices.

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[14] Teece, "OPEC Behavior," 65.

[15] Griffin, "OPEC Behavior," 956.

However, reality sometimes contradicted the claims of target revenue theory. In 1979, skyrocketing oil prices were mainly engineered by Saudi Arabia's decision to cut output, and this brought the kingdom an unexpected and substantial financial surplus. In the first half of the 1980s, Saudi Arabia organized its oil production to support certain price levels rather than in response to oil prices and target revenues. Furthermore, it is clear that its revenue needs were largely determined by its oil policy during the first half of the 1980s. When Saudi Arabia assumed the role of a swing producer from 1982 to 1985, it set out its revenue requirements for 1983, 1984 and 1985 at a considerably low level in comparison with 1981 and 1982 (see Table 5).[16] In David Golub's words, "far from revenue needs conditioning oil policy, oil policy appears to have conditioned revenue needs."[17] Hence, the claim that revenue requirements determine Saudi oil output is ahistorical.

Technical Problems in the Oil Fields

Another attempt to explain Saudi oil policy focuses on the technical problems in the country's oil fields, which are said to have affected decisions about oil production. According to this claim, Saudi Arabia's major decisions on oil production, particularly in 1973-74 and 1979 were the results of technical difficulties in the oil fields that made it necessary to reduce output during this period. Regardless of political and economic considerations, production cuts during this period were necessary to solve technical

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[16] Although Saudi Arabia began to play a swing producer role in 1982, Saudi revenue requirements for 1982 were high, because the budget for 1982 was based on the robust economy in 1981.

[17] David B. Golub, *When Oil and Politcs Mix: Saudi Oil Policy, 1973-1985* (Cambridge, Massachusetts: Center for Middle Eastern Studies, Harvard University, 1985), 5.

problems and to preserve the country's oil reserves to ensure the continuity of production.

Production in Saudi fields relies on the use of the natural pressure of oil and gas that forces the oil to the surface. However, as production continues, the pressure in the reservoir naturally declines, and oil fields need to maintain pressure by injecting either gas or water into the reservoir in order to ensure the long-term stability of production. Aramco's injection programs started in the early 1950s, and in 1954 it built its first gas injection plant to maintain pressure in the Abqaiq field, while a second gas injection plant was established at 'Ain Dar in 1959. During the development of Abqaiq and Ghawar, Aramco decided to inject water into the oil reservoirs, which was regarded at the time as the most efficient means of maintaining pressure, and this began at Abqaiq in 1956 to supplement gas injection. The company's water injection program was widely applied to many oil fields and the quantities of water injected into the oil reservoirs increased considerably during the 1960s and early 1970s.[18]

Some technical analysts such as Matthew Simmons argue that high levels of oil production caused technical problems that brought about restrictions on production in the giant oil fields including Ghawar, Abqaiq, and Safaniya. When oil is overproduced, this can generally cause technical problems caused by rapid gas cap formation and premature water encroachment. Therefore, overproduction usually leaves far more oil in the ground upon depletion than steady production at lower rates, and contributes to the deterioration of the oil fields.[19] According to this explanation, it was a necessary to cut oil production to solve technical problems in the major oil fields after they became devastated by

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[18] Nawwab, Speers, and Hoye, *Aramco and Its World*, 210-11.

[19] Matthew R. Simmons, *Twilight in the Desert: The Coming Saudi Oil Shock and the World Economy* (New Jersey: Wiley, 2005), 65-66.

overproduction.

In the context of the oil embargo in 1973, an Aramco official argued that the cutback resulted more from technical problems than from political considerations. Regardless of any political considerations during this period, Saudi Arabia would have cut its output because of problems in the oil fields.[20] Steven Emerson also accepts this reasoning: "severe pressure problems in certain Saudi oil fields had necessitated a severe production cutback in October and November 1973 – the same time as the Arab oil embargo."[21]

In addition to the 1973 oil embargo, Aramco officials alleged that technical problems had caused a reduction in oil production in the first half of 1979. Particularly, a staff report to the Subcommittee on International Economic Policy of the Senate Committee on Foreign Relations in 1979 supported this reasoning to explain the decision of the Saudi government to reduce production by introducing a new output ceiling in January of that year. This report indicated that problems caused by low pressure and water incursion in the Saudi major oil fields such as Abqaiq were a result of overproduction in late 1978.[22]

However, it is most likely that this claim on the part of Aramco officials was merely an attempt to evade the company's responsibility for the price rises caused by

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[20] Seymour M Hersh, "U.S. Experts Fear Saudi Toubles in the Oilfields May Limit Output," *New York Times* December 25, 1977, 1, 16.

[21] Steven Emerson, *The American House of Saud: The Secret Petrodollar Connection* (New York: Frankliin Watts, 1985), 147. According to his explanation, this important historical evidence had been deleted from the original report for the Senate Subcommittee on Foreign Economic Policy in 1979.

[22] Senate Committee On Foreign Relations, *The Future of Saudi Arabia Oil Production*, 96th Cong., 1st sess., 1979, Staff Report, 12-31.

their own decisions to reduce oil production, because the April Senate report was written based on documents subpoenaed from Aramco. As Quandt mentions below, the objectivity of the source is evidently in question, because it could have been fabricated by Aramco officials in their own defense.

> The source for this belief is an Aramco official testifying before a skeptical congressional committee while trying to defend himself against charges that American companies collaborated with Saudi Arabia in enforcing the embargo against the interests of the United States and Israel. It must have been very convenient in such circumstances to have been able to argue that Aramco's hands were tied because of technical problems in the oil fields.[23]

Therefore, these technical problems justified the collaboration of Aramco officials with the decisions of the Saudi government to reduce production in the first half of 1979. Although the market was tight and cuts in output would aggravate the uncertainty of supply, Aramco officials could say that they had no choice.

In contrast to the claims of Aramco officials, Saudi officials consistently denied the claim that the technical problems in their oil fields caused the cuts in oil production.[24] Yamani himself refuted this idea as illogical:

> I read that report, I had to smile. For a layman—not even for someone who knows about the oil business—the US reserve is about 38 billion barrels and they are producing almost what we are producing in Saudi Arabia, though our reserves are several times bigger than those of America and our oil fields are not exhausted as the US ones are. So the man in the street might even question that statement.[25]

He dismissed the claims of Aramco officials as a lie and argued that there were no

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[23] William B. Quandt, *Saudi Arabia's Oil Policy* (Washington, D. C.: The Brookings Institution, 1982), 13.

[24] Middle East Petroleum and Economic Publications, "Saudi Arabia," *Middle East Economic Survey* XXII, no. 21 (March 12, 1979): 12-13.

[25] "Post-OPEC Press Interviews- Saudi Arabia: Shaikh Ahmad Zaki Yamani," *Middle East Economic Survey* XXII, no. 24 (April 2, 1979): vii.

technical problems in the Saudi oil fields.

Whether or not there actually were technical problems in the Saudi oil fields, Saudi denial of this claim was highly political. If there were technical problems, and these really had caused cutbacks in production, there would be no reason for any Saudi denial, because technical problems in the oil fields might have been a useful way of deflecting blame from themselves for the cut, but they always denied it. It is most probable that their denial was based on political considerations, since any admission that technical problems in the oil fields had actually limited production capacity would have severely weakened Saudi Arabia's political leverage. By denying this, they could maximize their negotiating position vis-à-vis the United States and their neighbors by introducing the possibility of additional production. On the other hand, if there were no serious technical problems in the oil fields, the only remaining option for the explanation of Saudi oil policy in the early 1979, represented by the decision of the Saudi officials to cut back oil production and their denial of technical problems, was political.

It is highly possible that the Saudi decision to reduce oil production early in 1979 stemmed from political considerations, regardless of the existence of technical difficulties in the oil fields. Golub tried to show the unlikelihood of the "technical problems" argument by looking into the political situation of Saudi Arabia in detail during 1978-79. Decisions to reduce oil output in this period were attempts to protect the regime from internal and external threats in very trying political circumstances. Particularly, he indicated the flimsiness of the technical explanation by questioning the timing, phrasing, and mode of implementation of the January 20 announcement to introduce new production ceilings. The production cuts were only announced after considering the political exigencies at the time.[26]

Even with the lack of the evidence for a technical explanation, some oil industry experts still argue that Saudi oil policy decisions, when the country was a swing producer in the first half of the 1980s, were largely the result of problems in the major oil fields. Matthew Simmons, Chairman of Simmons & Company International, a specialized energy investment banking firm, pointed to the problems affecting the key super-giant oil fields, the so called "Big Three," Ghawar, Abqaiq, and Safaniya, which supplied over 80% of Saudi Arabia's oil in the 1970s and early 1980s, with reference to technical papers produced by the Society of Petroleum Engineers (SPE). According to his explanation, Saudi oil production peaked during 1978 – 1981, pushing Saudi Aramco's wells and reservoirs to their limit.[27]

While Saudi Arabia was overproducing its own oil by assuming the role of swing producer to compensate for the loss of Iranian and Iraqi production in the early 1980s, the major Saudi oil fields did in fact experience serious damage, causing profound and long-term harm to their sustainability. In this situation, Simmons argues, the cutback in oil production between late 1982 and early 1986 was part of a plan to protect and heal these fields from the damaging effects of overproduction rather than the result of Saudi decision-makers' efforts to keep oil prices at a certain level.[28]

However, his argument does not give plausible answers to some questions regarding Saudi Arabia's role as a residual supplier from 1982 to 1985. In March 1982,

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[26] For details of Saudi oil policy during this critical period, see Golub, *When Oil and Politcs Mix*, 13, 31-38.

[27] Simmons, *Twilight in the Desert*, 62-65.

[28] Ibid., 65-67.

Saudi Arabia accepted a production quota for the first time in the history of OPEC, contrary to its previous claim that every OPEC member has the right to control its own production. After OPEC's Extraordinary Conference on March 19-20, Yamani announced that if market conditions still threatened OPEC's pricing system even after the application of a Saudi quota of 7 million b/d, he would be willing to cut Saudi output further.[29] Although 7 million b/d of the Saudi Arabian production allocation was rather low in comparison with production in 1980 and 1981, the kingdom actually produced less than its own quota, approximately 6 million b/d during the second half of 1982.[30] If the decision to cut production was the result of technical problems, there was no reason for Saudi Arabia to have produced less than its allocated quota. In addition, between 1983 and 1985 Saudi Arabia produced less than half its production in 1980 and 1981, without any specific quota allocated to the kingdom in accordance with the London Agreement of March 14, 1983. This self-sacrificing behavior within OPEC cannot be explained in terms of technical problems in the oil fields.

Political Explanations

Economic explanations for Saudi oil policy within the framework of OPEC as a cartel could provide more plausible predictive and normative explanations during the oil boom. However, this kind of explanation, established on the basis of wealth maximization, did not show much consistency over time, particularly in the late 1970s.

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[29] Petroleum & Energy Intelligence Weekly, "Yamani Explains Saudi & OPEC's Strategy: Speical Supplement," *Petroleum Intelligence Weekly* XXI, no. 13 (March 29, 1982): 1-2.

[30] "PIW's Month-by-Month Breakdown of Total World Crude Oil and NGL Production for 1982," *Petroleum Intelligence Weekly* XXII, no. 9 (February 28, 1983): 8.

As a result, some researchers started to reconsider the major motivations of Saudi oil policy and introduced political factors as being key to shaping it. According to this school, the major decisions of Saudi oil policy were the outcome of political considerations rather than reflecting a form of strictly economic accounting that would maximize the wealth of the state over time. Individual commentators made different assessments of the contribution of political factors to the decisions of Saudi oil policy makers. However, it is generally accepted that the major decisions taken by Saudi Arabia at crucial moments in the history of the oil market were based on political considerations.

Some scholars have tried to mix all possible factors including political ones to explain Saudi oil policy. Charles Doran suggested that the oil policy of Saudi Arabia was based on political as well as commercial and economic considerations. He tried to understand the Saudi penchant for moderate oil prices from a political perspective, focusing particularly on the rivalry between Saudi Arabia and Iran, and explained the main political motivations for Saudi oil policy as follows:

> Rivalries exist among the OPEC states. Saudi Arabia is distrustful of Iranian military ambitions in the Gulf region, particularly looking forward to a time when Iranian petroleum reserves will have run out but Saudi reserves will offer a potential aggressor an inviting prize. Since high current prices for crude add to the Iranian military budget, Saudi Arabia has a persuasive reason for opposing marginal increments in already high oil prices.[31]

He regarded regional rivalry as a major political motivation, affecting Saudi oil policy in general.

Writing in the late 1970s, Doran regarded the perpetual unity of OPEC as a

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[31] Charles F. Doran, *Myth, Oil, and Politics: Introduction to the Political Economy of Petroleum* (New York: The Free Press, 1977), 142.

myth, although large numbers of people continued to believe in it.[32] He did not expect the cohesion of OPEC to last for long because of the difficulties of maintaining solidarity between partners with very different interests. A major factor that might lead to the failure of OPEC would be the ultimate reluctance of Saudi Arabia to assume the full burden of production constraint. The role of Saudi Arabia as a swing producer was regarded as a necessary precondition for the maintenance of OPEC's unity. However, he anticipated that the kingdom would not carry out this role within OPEC under the conditions of a soft market, because of the power struggles within the organization:

> Insofar as a reduced Saudi market share becomes accepted within the cartel and legitimized as fair, other governments such as Iran, Iraq, Kuwait, and Venezuela will obtain more influence over OPEC decision-making since the differential between the size of their shares and that of Saudi Arabia will have declined . . . Saudi Arabia could at some point decide to stiffen its current position . . . Such a decision to sacrifice current harmony for future leverage could shake the cartel to its foundation if other member governments become obdurate.[33]

He anticipated that Saudi Arabia would not assume the role of a swing producer under the conditions of a soft market because of its political interest in checking the power of neighboring countries, particularly Iran, and to secure its predominant position within OPEC.

His argument in favor of understanding Saudi oil policy as resulting from political considerations, specifically the rivalry between Iran and Saudi Arabia and the power struggles within OPEC, seemed plausible, although history has failed to validate

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[32] In terms of OPEC cohesion, Doran regarded the perpetual unity of OPEC as myth. However, the term "perpetual unity" as used in his book *Myth, Oil, and Politics* is somewhat misconceived, because OPEC represents the common economic interests of the oil industry, which produces a nonrenewable natural resource, oil. It is hard to apply the term of "perpetual unity" to OPEC on the basis of the common interests of an extractive resource industry.

[33] Doran, *Myth, Oil, and Politics*, 144.

his argument. According to his explanation, Saudi Arabia would be reluctant to take the role of a swing producer, particularly during a soft market situation. In fact, however, Saudi Arabia reduced it own production level well below the production quota allocated by OPEC in 1982 to sustain a certain price level. Furthermore, Saudi Arabia assumed the role of swing producer without any specific quota from 1983 to 1985 at the expense of the loss of its market share and actually went into deficit. Therefore, it is hard to apply this argument to Saudi oil policy.

David Long also suggested political considerations as one of the major motivations of Saudi oil policy. He argued that the oil policy of Saudi Arabia was determined by three major factors: revenue requirements, regional and international political and economic stability, and the maintenance of the predominant influence over price setting within OPEC. He acknowledged political factors as major motivations of Saudi oil policy. According to his explanation, in order to further the political and economic stability of the West, which alone could provide the kingdom with security from the threat of communism or any other radical ideology, Saudi Arabia produced more oil than it needed throughout most of the 1970s. However, Long also considered that other factors were involved, and that these might lead Saudi oil policy towards a different outcome. For example, if Saudi Arabia considered it a priority to keep its predominant position within OPEC, the kingdom would reduce its output to raise oil prices because this decision would satisfy the desires of other OPEC members to secure higher prices.[34]

Long did not assume that political considerations overwhelm other competing

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[34] David E. Long, "Saudi Oil Policy," *The Wilson Quarterly* 3, no. 1 (Winter, 1979): 83-91.

objectives. In other words, he did not explicitly indicate that a particular political motivation had priority over any other in determining Saudi oil policy. He simply cited three dominant factors without considering the circumstances in which one factor might predominate over others. Sometimes, the three different factors making up Saudi oil policy would even contradict each other. Therefore, his explanation has limitations in its attempts to find consistent patterns over time. In addition, he put forward little historical evidence to support these three major motivations of Saudi oil policy, which seem to be somewhat arbitrary without specific historical verification.

William Quandt deduced the major determinants of Saudi oil policy from the historical record, focusing particularly on economic and political considerations. He argued that Saudi oil policy contains a mixture of economic and political considerations. He tried to unravel its main principles on the basis of market situations and long-term economic interests in keeping up a high demand for oil. However, in two episodes, in October-November 1973 and the first half of 1979, Saudi oil policy reflected political considerations that were very far from its long-term economic strategy. In the first case, US foreign policy toward the Arab states during the October 1973 war increased the pressure from Saudi Arabia’s neighbors to use its oil as a political weapon. Although Quandt was not sure about the exact reasons in 1979, he acknowledged the high possibility of political considerations being a response to pressure from Iran or sending the US a signal of its unhappiness at the Egyptian-Israeli peace treaty.[35]

Quandt argued that economic considerations could be intermingled with political considerations in the case of Saudi oil policy, although it would be hard to figure out

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[35] Quandt, *Saudi Arabia's Oil Policy*.

which one of these had priority. However, he implicitly gave priority to economic considerations as he indicated that Saudi oil policy could generally be understood on the basis of long-term economic interest. He considered political explanations for Saudi oil policy as a useful tool on those occasions when the country's behavior deviated from its long-term economic interests. Although he acknowledged both economic and political considerations as crucial factors in the determination of Saudi oil policy, he seemed to understand that political explanations were an important supplementary factor, which could provide some plausible answers at moments when the behavior of Saudi Arabia seemed to run contrary to its long-term economic interests.

In contrast to Doran, Long and Quandt, who suggested that political considerations were one of the main determinants of Saudi oil policy and did not challenge the validation of economic considerations based on long-term wealth maximization strategies, Theodore Moran and David Golub tried to understand the decisions of Saudi oil policy makers purely on the basis of political motivation. According to their claim, political considerations were not supplementary to economic ones, but were the major motivation shaping overall Saudi policy, pushing economic explanations into second place. Therefore, even long-term economic interests were part of Saudi Arabia's political interests rather than playing themselves out as a major objective of the kingdom.

Moran took a pessimistic view of the value of existing economic models for the explanation of OPEC and Saudi oil policy and the future oil market. Although economic analysis has some normative and predictive power by providing a long-term price and production strategy for OPEC as well as Saudi Arabia under certain assumptions, this explanation, based on the assumption that OPEC as a cartel, is difficult to apply to the individual members of OPEC, all of whom have different economic interests which themselves produce a broad spectrum of oil policy. In addition, economic explanations show widespread discrepancies in estimating the future oil market as a result of the great uncertainties about the forecast of the supply side and the response of the demand side. Given that some major economic data of 1980 were presented at the Energy Modeling Forum in 1981, there was a wide range of predictions of oil prices, the production levels of OPEC and its revenues for 1984. Therefore, Moran believed that economic factors, focusing on wealth maximization, failed to provide any plausible or reliable explanations of either Saudi Arabian or OPEC oil policy.[36]

Because of inconsistencies in economic explanations for Saudi oil policy based on the economic optimization of its oil wealth, Moran suggested an accompanying alternative, the political explanation, for understanding Saudi oil policy. He argued that Saudi oil policy became a political priority based on security concerns, which aimed to minimize hostile internal and external pressures on the kingdom. It is generally believed that Saudi Arabia implements a policy of price moderation within OPEC to secure its long-term economic interests, although Moran argued that this was not always applicable during the oil boom period.[37] Sometimes, Saudi oil policy was directed against its own

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[36] Theodore H. Moran, "Modeling OPEC Behavior: Economic and Political Alternatives," in *OPEC Behavior and World Oil Prices*, ed. James M. Griffin and David J. Teece (London: George Allen & Unwin, 1982), 94-103.

[37] He indicated that economic factors could not be completely ignored, because even economic considerations were closely related to political and security concerns. Hence any deterioration in the world economy would encourage the emergence of leftist coalitions, especially in the West, which would increase political and security risks for the kingdom. As he regarded political and security concerns as primary to economic

long-term economic interests, and this resulted in periodic oil shocks and price rises. Moran believed that this seemingly economically irrational behavior of Saudi Arabia could be explained by political considerations, and that economic considerations were closely correlated with political priorities and security concerns.[38]

Moran tried to validate his argument by applying political interpretations to various historical events. Both the cancellation of the oil auction in 1974 and the 10% price increase in 1975 were the results of pressure from OPEC hawks, particularly Iran. Although the oil market was relatively weak, the decisions of Saudi Arabia did not reflect market realities because of high inflation and the weakness of the global economy during this period. Saudi attempts to pursue moderate prices in 1976 and 1977 were primarily attempts to alleviate pressure from the United States and to strengthen Saudi Arabia's own relationship with the US for the acquisition of F-15 fighters, rather than based on straightforward economic calculations. Although the market situation in this period was relatively strong with comparatively low inflation and a strong global economy and there were therefore strong indications that a price rise was appropriate, Saudi Arabia preferred a price freeze. The second hike in oil prices of 1979 was engineered primarily by the Saudi decision to make a cut in production in the first quarter of 1979, implicitly in reaction to the Camp David treaty and partly under pressure from other oil producing countries. On the other hand, the decision to freeze the price of oil at $32/b without a production cut at the meeting in Geneva in 1981 does seem to have been a reflection of a weak market situation. However, Moran argued that even though the decision of 1981

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considerations in Saudi oil policy, the former always overwhelmed the latter when the two conflicted.

[38] Moran, "Modeling OPEC Behavior," 94-103.

was the result of economic concerns, political and security considerations could not be ignored. This decision could be also understood as a political gesture to show the kingdom's good will towards the new American administration and to appeal to the US for a major arms package.[39]

Viewing these six historical events, Moran tries to show that the oil policy of Saudi Arabia had almost nothing to do with economic considerations such as the health of the world economy or the strength of the kingdom's financial institutions. According to his explanation, the major motivations of Saudi oil policy were not economic but political priorities and security concerns. More specifically, Saudi oil policies were mainly designed to eliminate or minimize external and internal threats to the security of the Saudi regime rather than to use its oil in an aggressive way to maximize its international standing.

Moran's historical analysis shows that Saudi Arabia tends to try to strengthen its ties with the United States by implementing favorable oil policies, unless the Arab neighboring countries exert considerable and immediate influences upon it. As a result of the declining influence of Britain in the Gulf during the 1960s, mainly because of the increasing financial power of the Gulf Arab rulers, ongoing domestic financial problems and increasing international pressures to roll back direct imperial control in the region, it was inevitable that Saudi Arabia should look for another superpower patron to provide regional stability and deflect external threats from such powers as Iran and the Soviet Union. Given that Britain had decided to recognize four independent new Gulf States, Oman, Qatar, Bahrain, and the United Arab Emirates in 1971 after the independence of

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[39] Ibid., 103-15.

Kuwait in 1961 and to withdraw formally from the Gulf in December 1971,[40] it is plausible that Saudi Arabia's political priority in the 1970s should have been to try to minimize potential political threats, particularly external pressure. The unfavorable political environment initiated by the impending departure of Britain in the 1950s and 1960s must have encouraged Saudi Arabia to establish closer relations with the United States as long as there were no serious threats from neighboring countries.

In contrast to Moran, Paul Stevens interpreted the political objectives of Saudi oil policy as ways of maximizing political power. Although he acknowledged the contribution of nonpolitical objectives to Saudi oil policy, he believed that they were subordinate to political motivations. He considered that Saudi oil policy had two different objectives, to maintain and strengthen Saudi security and stability, and to increase the country's influence both in the Arab world and in the world in general. Other objectives were clearly subordinate to these two principal goals. The long-term economic health of Saudi Arabia, a secondary objective of Saudi oil policy, contributes to the first main objective, ensuring the country's security and stability. This subobjective requires not only price moderation and enhanced production but also control of Aramco by the government and the full integration of the oil industry into the economy through the acquisition of technology and expertise. To achieve the second main objective, to secure a more influential voice for Saudi Arabia in the world as a whole and in the Arab world, the kingdom should show its mettle as a responsible member of the international community by implementing an oil policy that would support the health of the Western economy and to check the expansion of communism. In addition, the settlement of the

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[40] Foley, *The Arab Gulf States*, 43-46.

Arab-Israeli conflict and the broad encouragement of Islam in the world would help the kingdom enhance its position both regionally and internationally.[41]

On the other hand, Stevens' claim that Saudi Arabia wanted to have more influence at regional and international levels is highly questionable. It seemed to be using its oil resources defensively to secure its own national security and stability rather than to expand its influence regionally and internationally. Its increasing influence necessarily required price leadership within OPEC, which would of course be possible with the expansion of production capacity. However, although Saudi Arabia was producing at almost maximum capacity in 1980 and 1981 to stabilize the price of oil, it failed to achieve its objective. Hence, it could not exert its price leadership without the installation of larger productive capacity. If the Saudis wanted to have more political and economic influence in both regional and international affairs, they should have expanded their production capacity, which they did not.

During the second half of the 1970s, Saudi Arabia did not expand its production capacity as the kingdom planned. In December 1976, when it tried to exert its price leadership at the OPEC meeting in Doha, it was seriously challenged by other OPEC members, particularly Iran and Iraq, who insisted that the price should be increased by 15% and 26%, respectively, while Saudi Arabia proposed a zero increase. To achieve Saudi Arabia's goal at the meeting, Yamani announced that it could expand its production level up to a maximum capacity of 11.8 million b/d and was seriously considering production capacity of 13.4 million b/d by January 1980, 14.2 million b/d by

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[41] Paul Stevens, "Saudi Arabia's Oil Policy in the 1970s: Its Origins, Implementation and Implications," in *State, Society and Economy in Saudi Arabia*, ed. Tim Niblock (London: Croom Helm, 1982), 226-29.

January 1981 and 16.2 million b/d by December 1982.[42] However, for political reasons, his ambitious plan to expand Saudi production capacity was never implemented.

It is clear that the expansion of production capacity does not coincide with the political interests of Saudi Arabia. According to Quandt, a major expansion of production capacity would expose Saudi Arabia to pressures not only from other OPEC members but also from the West. The other OPEC members would suspect that it would use its increased capacity to lower oil prices and press it not to use its oil resources in that way. At the same time, the Western oil consuming countries would exercise their influence on Saudi Arabia to increase oil production to moderate the price of oil. In addition, the plan to expand production capacity would generally give the Saudi people a negative image of their government, because such action would imply collaboration with the West. This policy would definitely not be popular and would possibly encourage domestic political opposition.[43]

As Moran argued, it is more plausible that the main objective of Saudi oil policy was to advance its political priorities and to secure its national security from external and internal threats in a cautious, defensive and reactive way. Hence, its policy was more a way of reacting to increasing external and internal pressures than an active means of increasing its influence in the Arab and international community. Although Stevens

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[42] Middle East Petroleum and Economic Publications, "Leaked State Department Cable Threatens Progress of CIEC: Saudi Arabia," *Middle East Economic Survey* XX, no. 9 (December 20, 1976): 2; "Two Papers by Yamani: Arab Oil and World Politics," *Middle East Economic Survey* Supplement to XX, no. 11 (January 3, 1977): 5-6; "Some OPEC Interviews: A MEES Round-Up (Saudi Arabia)," *Middle East Economic Survey* Supplement to XX, no. 12 (January 10, 1977): 7; "Saudi Arabia," *Middle East Economic Survey* XX, no. 48 (September 19, 1977): 2.

[43] William B. Quandt, *Saudi Arabia in the 1980s: Foreign Policy, Security, and Oil* (Washington, D. C.: The Brookings Institution, 1981), 126.

suggested that Saudi involvement in the settlement of the Arab-Israeli conflict and its encouragement of Islam throughout the world were subobjectives that contributed to giving Saudi Arabia an increasing voice at both regional and international levels, it would be more persuasive to argue that these subobjectives were adopted to reduce its political vulnerability to internal and external threats. Without the settlement of the Arab-Israeli conflict, it would be difficult to expect any regional stability, which would in turn provide Saudi Arabia with a favorable political environment by minimizing both internal and external threats. In addition, the propagation of Islam contributes to the consolidation of political power of the Āl Sa‘ud, because Islam provides the Āl Sa‘ud with political legitimacy.

Although Moran indicated political priorities and security concerns as major motivations of Saudi oil policy, he did not specify what these political priorities actually were. He tried to distinguish between political priorities and security concerns, but he failed to identify specific political priorities for Saudi Arabia except for security-related matters.[44] In addition, focusing on the predominant role of political motivation in Saudi oil policy, Moran and many others could not validate the irrelevance of the economic explanation to the decisions of Saudi oil policy where political motivations happened to coincide with long-term economic interests.

David Golub tried to solve all these questions with a detailed historical analysis of two important periods, respectively, 1973-74 and 1978-79. He suggested that security-related concerns dominated all other political priorities in Saudi oil policy, and thus implicitly equated political priorities with security-related concerns. He argued that a host

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[44] Moran, "Modeling OPEC Behavior," 94-130.

of international, regional and internal forces constituted hostile external and internal pressures that threatened the stability of the Saudi regime and therefore considerably influenced its oil policy. Internationally, Saudi Arabia had a strong desire to maintain close relations with the United States, fearing not only political instability and the spread of communism, but also the increasing influence of the Soviet Union in the Middle East. At the regional level, Saudi Arabia was afraid of its militant neighbors such as Iraq and Syria (and Iran after 1978-79), and was concerned about the radicalization of the Arab world and the possibility of terrorist attacks on its oil facilities. At the same time, the Saudis wanted to maintain the existence of OPEC and have close relations with Egypt, and also did not want to be excluded from inner circles of the regional powers-that-be by not showing their sympathy for the Palestinian cause or not supporting claims for the liberation of Jerusalem. Internally, the Saudi regime wanted to use its oil revenues to strengthen its domestic status and felt a strong responsibility for increasing world and domestic concern about the inequity of the Arab-Israeli issue. On the other hand, it also had concerns about over-rapid socioeconomic development and the negative effects this was having on Saudi society and the prolonged discord within the royal family.[45]

While acknowledging the difficulty of enumerating all these forces in a permanent hierarchy because of constant changes in the order of their relative importance, Golub tried to find consistent patterns in the actions of the Saudi regime. According to his explanation, the events in 1973-74 and 1978-79 that resulted in skyrocketing oil prices as a result of Saudi Arabia’s decision to reduce oil production were not voluntary actions to show its political willingness to achieve certain political

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[45] Golub, *When Oil and Politcs Mix*.

goals, but were risk-averse reactions to increasing pressures from neighboring Arab countries during periods of crisis. For its main political priority, the survival of the regime, the decisions of the Saudi ruling family seem to have been established on the basis of a risk-averse strategy. During crisis periods, the serious short-term dangers emanating from the militant Arab states took precedence even over long-term economic interests. These risk-averse induced decisions were often deferred as long as possible in the hope that unfavorable political situations would be changed or eased. These short-term risk-averse decisions might even alienate Saudi Arabia from the United States, although the kingdom could not be estranged from the United States for any length of time because of their special economic and military relationship.[46]

Golub's analysis of the patterns of Saudi oil policy during various crisis periods does correlate with the historical record. By highlighting some of the behavior patterns of the Saudi regime, he tried to suggest that future decisions would be made within fairly limited parameters. Believing that long-term economic interests were not seriously embedded in Saudi oil policy either during crises or at "normal" times, he showed that political considerations, particularly security-related concerns, were the predominant motivations behind Saudi oil policy. He represented the OPEC conference at Doha in December 1976 as an example for the irrelevance of economic considerations to Saudi oil policy. Under the assumption that Saudi Arabia's economic interests were based on price maintenance, the decision of Saudi Arabia to refuse to increase oil prices more than 5% was not motivated by economic considerations. Because of the strong market situation and high inflation at that time, Saudi Arabia should have increased oil prices more to

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[46] Ibid.

satisfy its price maintenance strategy. In his opinion, this decision was based on the Saudis' desire to improve relations with the new administration of Jimmy Carter.[47]

However, Golub simply regarded price maintenance as the principal long-term economic interest of Saudi Arabia without any specific theoretical economic analysis, focusing on wealth maximization. According to the dominant producer model, which closely reflects the reality of the world oil market, relatively moderate oil prices, which could maintain oil demand at a certain desirable level and discourage any large-scale development of alternative energy sources, were at the heart of Saudi Arabia's long-term economic interests.[48] Given the context of the world oil market in late 1976, it is hard to say that Saudi Arabia's decision at Doha in December 1976 not to increase oil prices to 10% like other OPEC members was only motivated by political considerations.

Saudi Arabia officially explained that it could not increase oil prices more than 5% in December 1976 in the hope that this would contribute to the recovery of the world economy. Before the OPEC ministerial Conference in Doha, in doubt about the extent of world economic recovery, Yamani explained, "Developments in the past month have shown that the world economic recovery is not as strong as we first thought. We have therefore changed our position and no longer think an oil price increase would be reasonable."[49] In an interview after the conference, Yamani explained more specifically why the recovery of the world economy is important:

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[47] Ibid., 46-47.

[48] As we will discuss in Chapter VII, Saudi Arabia did not want any excess oil demand, which would also challenge its long-term economic interests.

[49] Middle East Petroleum and Economic Publications, "Saudi Arabia: Yamani Says Saudi Arabia is against Any Oil Price Increase for next Six Months," *Middle East Economic Survey* XX, no. 9 (December 20, 1976): 2.

> There were important economic and political reasons . . . We are extremely worried about the economic situation in the West, worried about the possibility of a new recession, worried about the situation in Great Britain, Italy, even in France and some other countries. And we do not want another regime to come to power in France or Italy.[50]

His explanation has persuasive power, because the world economic recovery would not only bring Saudi Arabia, sharing strong political and economic interests with the West, particularly the United States, huge economic profits from its investments there, but would also provide the kingdom with politically favorable environments by preventing the expansion of communist influence in the Middle East and the West. However, given that the world economy was continuously recovering in 1977 and 1978, producing an annual world GDP growth rate of 4%,[51] Saudi Arabia's constant calls for a price freeze vis-à-vis the OPEC price hawks during this period seems a poor excuse, meaning that there must have been some real reasons behind the decision in December 1976.

Although the Saudi leaders did not make any public expression of their concern about the development of alternative energy sources, growing discourses to this effect after the unprecedented fourfold increase in oil prices from the Arab oil embargo in 1973-74 would have caused them great concern, and led them not to call for increases in prices as much as other OPEC members. As early as June 1976, the American oil expert Walter Levy pointed out in a confidential report entitled "OPEC in the Middle Term" that a sharp increase in oil price would accelerate the development of alternative energy sources, which would certainly threaten Saudi Arabia's long-term economic and political

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[50] "Some OPEC Interviews," 8.

[51] World Bank, "World Data Bank: World Development Indicators," The World Bank, http://databank.worldbank.org/data/views/reports/tableview.aspx?isshared=true&ispopular=series&pid=1 (accessed April 27, 2014).

interests.[52] It was clear that Saudi Arabia, possessing huge oil reserves, equivalent to approximately a quarter of world reserves, would be one of the principal victims of the rapid replacement of oil by other energy sources. After the Arab oil embargo in 1973-74, the world oil market experienced a decrease in demand in 1975 for the first time since 1950. Saudi Arabia absorbed about 40% of the reduction in OPEC oil demand in 1975 (see Table 2). Enjoying huge oil revenues immediately after the Arab oil embargo, Saudi Arabia realized that high oil prices could do unprecedented damage to demand. These developments should have also strengthened the anxiety of the Saudi leaders about the rapid replacement of oil by alternative energy sources. Under a situation in which no one knew what level of prices would encourage massive alternative energy production and in which the world oil market had already experienced decreasing demand, the Saudi leaders' main concerns were to try to prevent further sharp price increases being pursued by other OPEC members.

With the comprehensive analysis of Yamani's explanations and the historical background to this period, one could conclude that the long-term economic interests of Saudi Arabia were not simply embedded in price maintenance, but in price moderation. This would ensure the continuing use of oil as a major energy source and discourage the development of alternative energy sources. At the same time, a policy based on price moderation would also prevent the world economy from a slowdown or a recession and consequently bring economic prosperity in the West. Therefore, Golub's argument that political considerations have priority over economic interests in Saudi oil policy even during normal times after the event of 1976 does not have any persuasive power, because

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[52] Pierre Terzian, *OPEC: The Inside Story*, trans. Michael Pallis (London: Zed Books Ltd., 1985), 251.

Saudi oil policy in 1976 also coincided with both their political and economic interests.

Under circumstances in which there were no serious political exigencies, a policy of pursuing price moderation on the basis of long-term economic interests of oil wealth maximization coincides with Saudi Arabia's long-term political interests, that is, the stability of the Saudi regime against internal and external threats. As mentioned in Chapters II and IV, Islam, the rentier state, and cooperation with the West are crucial factors in sustaining the Saudi regime. As high oil production with relatively moderate oil prices, which results in the continuous influx of revenues into the treasury, would not only maximize Saudi profits in the long run, but also bring about a more favorable political environment by allowing the regime to strengthen all these three factors, their political stability could be enhanced. A continuous financial revenue stream could be used to support religious institutions upholding the political legitimacy of the Āl Saʻud and make the religious establishment subordinate to the Saudi regime. The Saudi government must also have believed that a rentier sate could bring about a more favorable political environment by making its population more politically quiescent. As relatively moderate prices do not seriously challenge the demand for oil, and secure a certain portion of Saudi Arabia's market share, it can sustainably secure its oil income to support a rentier state financially. In addition, as mentioned above, this policy would provide the West with an economically healthy environment and the political stability of Western regimes against the threats of the common enemy, communism. The economic prosperity of the West also brings the Saudi government financial profits through the returns from huge foreign investments as a part of petrodollar recycling. Furthermore, as the Saudi government presents the image of Saudi Arabia producing more oil than it needs for the political and economic interests of the West, it might expect some political and economic compensation and military cooperation from Western countries.

Therefore, it is not so important to distinguish which one has priority over the other during normal times, because long-term economic and political interests in Saudi oil policy do not contradict each other; rather, they show a degree of complementary cooperation. In reality, both long-term political and economic interests have led Saudi Arabia to decide its oil policy in the same direction during normal times, and it would be difficult to discover precisely which one has played the leading role in particular decisions. Although the pursuit of long-term economic interests would contribute to the formation of more favorable political circumstances, it is hard to say with certainty that hypothetical future security-related concerns have always had priority over long-term economic benefits even during politically normal times. However, as we can witness, at various times in the country's history, political exigencies related to short-term security concerns have sometimes necessitated sacrificing Saudi Arabia's long-term economic goals.

A political analysis of Saudi oil policy shows that Adelman's claims are largely irrelevant in the context of Saudi decision-making. His argument that Saudi Arabia has sought to maximize its oil revenues by engineering skyrocketing price rises at propitious moments seems to be plausible,[53] but this behavior has not coincided with the long-term economic and political interests of the regime. In addition, a detailed historical analysis of Saudi oil policy makes it clear that Adelman's conclusion is ahistorical, because the decisions to reduce oil production in 1973 and 1979 were not part of a well-orchestrated

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[53] Adelman, "The Changing Structure," 3; "OPEC as a Cartel," 45-49.

strategy to maximize oil revenue in advance but were instead somewhat cautious and reactive actions in response to increasing internal and external pressures.[54] Because of the importance of Saudi Arabia in the world oil market, with its large oil reserves and production capacity, its politically motivated decisions during crisis periods coincidentally resulted in unprecedentedly high oil prices and brought it huge amounts of extra money in the short-term. However, these decisions were certainly made at the expense of the state's long-term economic interests, encouraging a fall in demand and an increase in non-OPEC production, and also affected its long-term political interests, making it difficult for the regime to provide its population and the religious establishment with the level of financial support to which they had become accustomed, as well as making the West economically depressed and vulnerable to the threats of communism.

During normal times without any internal or external political crisis seriously threatening the existence of the kingdom, Saudi oil policy was conducted on the basis of trying to secure relatively moderate prices with high production levels under tight market conditions, which satisfied the state's long-term economic interests. At the same time, these decisions contributed fortuitously to a long-term guarantee of Saudi security on the basis of financial support for the Saudi people and the Wahhabi establishment, a healthy Western economy and close relations with the West, particularly the US. Although it is hard to know exactly which motivations were uppermost for Saudi oil policy-makers in this case, one thing is clear: the security-related short-term political considerations played a predominant role over long-term economic interests during the various political crises that threatened the existence of the regime.

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[54] For more details in these events, see Golub, *When Oil and Politcs Mix*.

An oil policy motivated purely by security related political considerations incurred considerable losses for Saudi Arabia in the 1980s. A politically driven oil policy in the short-term in the face of immediate political threats to the Saudi regime in 1973 and 1979 resulted in unexpectedly high oil prices, which consequently encouraged a decline in oil demand and an increase in non-OPEC production. The soft market situation in the 1980s triggered by these political events severely undermined the bargaining power of the Saudi regime not only vis-à-vis oil consuming countries, but also oil producing countries, because the notion that oil could be used as a political weapon was no longer valid for the consuming countries, and Saudi Arabia faced increasing pressure from OPEC members to reduce its production dramatically to assist OPEC against the tide of market forces. In the slack market situation during the 1980s, primarily triggered by an oil policy that reflected short-term political urgencies, Saudi Arabia was obliged to assume the undesirable role of swing producer in the world oil market to secure its long-term economic interests of oil wealth maximization at the expense of its own economy in the mid-1980s to a fairly devastating extent.

In addition to the economic explanations, the previous studies, focusing on Saudi oil policy from political perspectives, failed to explain why Saudi Arabia tried to hold up relatively high OPEC prices and what main factors contributed to the demise of this particular policy. Some authors have tried to attribute Saudi Arabia's assumption of the role of swing producer to political motives, focusing mainly on the amicable and semi-clandestine relationship between the kingdom and the US based on a basic bargain of oil for security guarantees. Thus, Al Rasheed argues that Saudi Arabia's preference for low oil prices during the 1970s was largely based on its relationship with the US, which was intended to secure the regime against internal and external threats.[55] Rachel Bronson also argues that Saudi Arabia had developed and sought a close relationship with the US, receiving security in exchange for supporting a moderate oil price. Saudi Arabia's policy of providing oil at a reasonable price for consumer countries allowed it to shelter under an overarching security umbrella that the US provided.[56] From the perspective of the US, the cooperation of Saudi Arabia on the world oil market made it easier to take sanctions against less friendly, even threatening, oil exporters, which might damage the interests of the US. Hence, Saudi Arabia's strategic position became even stronger and more important for the US. In particular, Bronson considers that the US-Saudi partnership was an outcome of the Cold War and that it functioned efficiently given the political realities. Therefore, the foreign policy concerns of Saudi Arabia during the Cold War largely coincided with those of the US. According to this argument, the ultimate goal of foreign policy elites in both countries was to reduce or eliminate opportunities for Soviet penetration in the Middle East and to stabilize the region.

Although there were some differences in the details on the means of achieving these common goals, the two countries generally cooperated. The US-Saudi partnership reached its peak in the 1980s in Afghanistan, as both made an effort to defeat the Soviet Union.[57] However, Bronson and Al Rasheed failed not only to explain why Saudi Arabia kept its role as a swing producer in the early 1980s, which could be explained by the dominant producer model, but also provide reasons why it first supported relatively high

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[55] Al-Rasheed, *A History of Saudi Arabia*, 140-43.

[56] Bronson, "Understanding US-Saudi Relations," 373.

[57] Ibid., 384.

prices by cutting its own production and then suddenly gave up this policy in 1985. Neither of them found any correlation between US support for the Saudi regime in the Cold War context and Saudi oil policy in the first half of the 1980s.

These two authors only focus on the role of Saudi oil policy as a supplier of last resort, which can stabilize oil price by increasing its oil output to prevent skyrocketing oil prices when the world oil market suffers from shortages, particularly during an oil boom. They argue that Saudi Arabia has been rewarded with the provision of security by the US, because it has compensated for shortages by increasing production. However, they disregard the slack market situation in the 1980s without giving any detailed explanations, even though Saudi Arabia tried to keep relatively high prices during this period by dramatically reducing its oil output in contrast with its expected role of moderating oil prices in return for political rewards from the US. Saudi oil policy in the early 1980s hardly seems to reflect an underhand deal between Saudi Arabia and the US based on moderate oil prices in exchange for security. Therefore, this perspective only provides limited explanations of Saudi Arabia's oil policy during the boom period.

Robert Mabro puts forward another interesting approach, although this too has its limitations in explaining Saudi oil policy in the first half of the 1980s. He suggests that Saudi Arabia's role in the first half of the 1980s was related to the identity and raison d'être of OPEC. If Saudi Arabia is in some sense emblematic of OPEC, it identifies its own role within OPEC as a swing producer. Since the creation of OPEC, its identity and raison d'être have been uniquely related to the defense of the price of oil. Therefore, Saudi Arabia made an effort to prevent prices from collapsing since this might bring about the demise of the organization.[58] However, this does not explain the events of mid-1985, when Saudi Arabia suddenly gave up its role of swing producer. This did indeed bring about a collapse in the price of oil as well as threatening the existence of OPEC.

Even Golub, who emphasized political factors in explaining Saudi oil policy and offers many deep and detailed insights, also failed to provide a plausible lens for examining the motivations of Saudi decision-makers under the slack market conditions of the first half of the 1980s. He simply suggested that the marked decline in OPEC oil demand and the continuing Iran-Iraq War were major factors influencing Saudi oil policy in this period. With only these two factors, it is hard to understand the full story regarding Saudi oil policy in this period, and several questions remain unanswered. The decrease in demand for oil alone does not give a complete picture of the structural changes in the world oil market during the 1980s, which greatly constrained Saudi Arabia's policy maneuverability. Regardless of the changing political interests of Saudi Arabia in relation to Iran and Iraq during their eight years of war, he simply regarded Saudi fears of an Iranian victory as the sole major incentive behind the increase in production in 1985. On the regional or international level, other political factors also affected Saudi oil policy during this period. It should be noted how far oil policy interacted with Saudi domestic political topography. These studies will be discussed in the next chapters in order to find answers for the main questions of my dissertation.

[58] Mabro, "OPEC after the Oil Revolution," 30.

CHAPTER VII

SAUDI OIL POLICY DURING THE OIL BOOM

Because of the limitations of previous studies, particularly those using the dominant firm model and those focusing on political explanations, for an explanation of why Saudi Arabia played the role of swing producer, defending relatively high oil prices in the first half of the 1980s and eventually giving up this mission in 1985, it is necessary to give a new historical interpretation of the mechanisms of Saudi oil policy. In the process, we should first understand the basic assumption of this policy during the oil boom period, which continued well into the 1980s. Because Saudi Arabia's role as a "swing producer" was not simply confined to the 1980s, we should look into its oil policy in previous years. Different authors use different milestones to define when exactly Saudi Arabia emerged as a swing producer on the world oil market. However, there is no doubt that it became a key player in determining the level of world oil prices in the course of the 1970s, and was the swing producer from this period onward. The ways in which it acted during the oil boom were different from those in the first half of the 1980s. For example, while it increased its output in order to achieve stability for the world oil market in the former case, it adversely cut its output in the latter case. However, there should be a common denominator that explains the essential character of Saudi oil policy as a swing producer in these two different time periods.

This analysis begins with the Doha Conference in December 1976, which resulted in a two-tier pricing system within OPEC for the first time in its history. After this meeting, Saudi Arabia began to raise its voice in earnest to implement its own oil policy within OPEC. There was virtually no consistent Saudi oil policy (that is, based on long-term economic interests) before December 1976. In particular, Saudi policy during the Arab oil embargo in 1973-74 and afterwards (including 1975) will not be discussed in this chapter, because in this period Saudi oil policy was not based on the government's own will, but was rather the reflection of increasing pressures from its Arab neighbors. [1] It was only after Saudi government's decision to nationalize Aramco in 1976 that Saudi Arabia was in a position to affect the world oil market by implementing an oil policy of its own. The Doha Conference in December 1976 was the first time that the Saudi government clarified its oil policy based on its long-term economic interests, which also satisfied its long-term political interests.

It is not easy to trace any consistency in Saudi oil policy, particularly during the oil boom after December 1976, because there were many contradictory comments by Saudi officials. This has pushed many researchers in different directions with their own fragmentary and partial historical information. There are two main reasons why Saudi policy-makers in this period seemed to show sometimes contradictory and inconsistent patterns of behavior. First, the general discourse, particularly in the late 1970s both within the industry and among academics, about the gloomy prospects for the future of the oil market, led Saudi officials to send warning messages about a possible future energy crisis to the oil-consuming countries. At that time, these messages seemed not to

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[1] See Golub, *When Oil and Politcs Mix*, 8-24.

reflect Saudi Arabia's long-term economic interests, which were based on the maintenance of moderate oil prices. Therefore, many researchers regarded these alarming messages as deceptive, in order to raise Saudi Arabia's official marker oil price under the pretext of a future energy crisis. However, as any future supply shortage would have eventually undermined Saudi Arabia's long-term economic strategy as the dominant firm in the world oil market, the Saudi leaders probably needed to take preemptive measures against a future energy crisis in order to secure their long-term economic interests. Secondly, political events at the regional level were challenging Saudi Arabia's political security and made the regime vulnerable to increasing pressures from its neighbors. As a result, the autonomy of its oil policy became rather restricted, at least temporarily, and the Saudis were obliged to implement a policy that deviated from their long-term economic interests in order to meet short-term political exigencies. Because of these two variables, researchers have found it difficult to understand the essence of Saudi oil policy during the oil boom. In this chapter, I will discuss the main priorities of Saudi oil policy and how the discourse on the future oil market and political exigencies affected the behavior of oil policy decision-makers.

Price Freeze Until 1978

Saudi Arabia's long-term economic and political interests were strongly embedded in moderate oil prices during normal times, particularly between December 1976 and the end of 1978, when it tried to achieve a price freeze. At Doha, its effort to achieve moderate oil prices resulted in the two-tier price system, and it tried to increase its oil production in order to persuade other OPEC members to follow suit in 1977. In addition to the consideration of Saudi relations with the United States, the psychological impact of the unprecedentedly high oil prices, caused by the Arab oil embargo in 1973-74, on oil policy decision-makers in Saudi Arabia led them to oppose any sharp price rises.

In the process of achieving moderate oil prices, the disagreement on prices within OPEC in December 1976 most likely caused a serious division of opinion on oil policy within the Saudi administration. After facing strong opposition from most OPEC members against a price freeze, Saudi Arabia, together with the United Arab Emirates, decided to raise its prices by only 5% at the OPEC meeting in December 1976, while other members decided to increase the price of $11.51 per barrel (the former price of Marker Crude) to $12.70 per barrel as of January 1st, 1977, and to $13.30 as of July 1st, 1977.[2] To achieve price unification in its favor, the Saudi government removed the 8.5million b/d ceiling on Aramco's output and was prepared to allow production to expand to a maximum of 11.8 million b/d if that was what would be required to persuade other OPEC members to follow the kingdom's oil policy.[3] However, this plan did not materialize completely, probably because there were conflicting opinions within the Saudi administration regarding oil policy and related technical problems, in spite of Fahd's denial in an interview with the Kuwaiti daily *al-Siyasah* on April 16, 1977.[4] There

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[2] OPEC, *Official Resolutions and Press Releases*, 144.

[3] Middle East Petroleum and Economic Publications, "OPEC Round-Up: Saudi Arabia," *Middle East Economic Survey* XX, no. 10 (December 27, 1976): i.

[4] "Saudi Arabia: Saudi Price Moderation Not Designed to Hurt OPEC, Says Fahd," *Middle East Economic Survey* XX, no. 27 (April 25, 1977): 2.

was a major fire at Abqaiq on May 11[5] and it is highly possible that such problems may have given rise to increasing dissatisfaction over oil policy within the administration. Relatively low Saudi oil prices in comparison with other OPEC members, without any meaningful compensation for production increases was enough for many officials to question the direction of Saudi oil policy. As the Shah mentioned in the Cairo daily *al-Jumhuriyah* on May 19, 1977, "oil is sold at one price, and the difference goes to the oil companies at the expense of the Saudi treasury"[6]; hence there was increasing dissatisfaction with relatively low oil prices within the Saudi administration. In an interview with the Beirut daily *al-Anwar* on May 21, Fahd stated that "the Council of Ministers decided after the return of His Majesty King Khalid to the country to raise the salaries of employees, following the increase in army salaries, so that every person can earn what he deserves."[7] From this interview it seems likely that the reported damages to the Saudi oil fields, possibly as a result of overproduction to achieve moderate oil prices within OPEC, may have caused increasing concerns and dissatisfactions on the part of Saudi government employees over oil policy, and that the government reacted by raising their salaries.

In fact, the technical problems in the Saudi oil fields had a limited influence on

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[5] "Aramco Plans to Restore Production within a Few Days after Big Fire at Abqaiq," *Middle East Economic Survey* XX, no. 30 (May 16, 1977): 3; After the incident in May 1977, another small fire broke out in the Abqaiq area on June 4 which was extinguished within a few hours. See "Saudi Arabia: Small Fire at Abqaiq Quickly Extinguished," *Middle East Economic Survey* XX, no. 34 (June 13, 1977): 6.

[6] "OPEC: Indonesia Confirms Agreement among Majority to Drop 5% Mid-Year Price Increase (Iran)," *Middle East Economic Survey* XX, no. 32 (May 30, 1977): 6.

[7] "Fahd Outlines Saudi Policy on Eve of Washington Visit," *Middle East Economic Survey* XX, no. 32 (May 30, 1977): vi.

oil production. According to Terzian, these unexpected technical problems and subsequent restrictions on oil production compelled Saudi Arabia to agree on an oil price increase with other OPEC members in July 1977.[8] However, this argument seems weak. The upper tier price countries did not experience a serious or harmful loss of volume during the first quarter of 1977 because of a combination of strong demand and Saudi Arabia's failure to achieve its first quarter output target of 10 million b/d.[9] Although Saudi Arabia failed to produce its target of 10 million b/d in the first quarter of 1977, it is hard to find any evidence that technical problems were the principal cause. Saudi production almost reached its target level in February and March, reaching 9.62 million b/d and 9.85 million b/d.[10] January was the only month where there was a serious drop in oil production, recording 8.28 million b/d, because of bad weather which reduced loading time at the Ras Tanura export terminal by as much as 60%.[11] The optimistic forecast for oil output in the second and third quarters of 1977 actually encouraged other members of OPEC to move towards price moderation, and the figure of 10.2 million b/d in April required some countries to cut production. Thus, Iran's production dropped to 5.41 million b/d in April from 6.28 million b/d in March.[12] Although the fire at Abqaiq slowed

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[8] Terzian, *OPEC*, 246-47.

[9] Middle East Petroleum and Economic Publications, "OPEC Majority Drop Scheduled Mid-Year Oil Price Rise," *Middle East Economic Survey* XX, no. 30 (May 16, 1977): 2.

[10] "Crude Oil Production 1977," *Middle East Economic Survey* XXI, no. 25 (April 10, 1978): i.

[11] "Saudi Arabia: Saudi Production Falls below Expectations in January," *Middle East Economic Survey* XX, no. 18 (February 21, 1977): 1.

[12] "OPEC Majority " 2; "Crude Oil Production 1977," i.

Saudi production to 8.37 million b/d in May, the fire-related technical problems were soon solved and Saudi oil production gradually increased to 9.54 million b/d in June and 9.71 million b/d in July.[13] More precisely, the general increase in Saudi oil production with occasional exceptions in the first half of 1977 led the majority of members of OPEC to compromise with Saudi Arabia over the reunification of oil prices within OPEC. The technical problems in the Saudi oil fields were not such as to oblige Saudi Arabia to come to an agreement with other members of OPEC.

The efforts of Venezuelan President Carlos Perez to reunify OPEC's prices contributed to the narrowing of differences between Saudi Arabia (and the UAE) and the OPEC majority on oil prices.[14] The Venezuelan President Carlos Perez made a visit to the Gulf states in April 1977, and succeeded in persuading at least Kuwait and Qatar not to go ahead with the extra 5% increase in July, in line with his own country. However, Saudi Arabia first rejected the proposal that it and the UAE should raise prices a further 5% to 10% so as to reunify the OPEC price structure even if the 11 other OPEC members agreed not to make their projected additional 5% increase in July.[15] This uncompromising attitude must have been contrived to exert pressure on two influential OPEC hawks, Iran and Iraq, during Perez's negotiation with them on his next visit to the region rather than expressing a genuine desire on Saudi Arabia's part to continue its oil policy. This strategy

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[13] "Saudi Arabia Plans to Maintain Export Level in May," *Middle East Economic Survey* XX, no. 31 (May 23, 1977): 3; "Crude Oil Production 1977," i.

[14] "OPEC: Venezuelan President Likely to Mediate in OPEC Price Split," *Middle East Economic Survey* XX, no. 26 (April 18, 1977): 4; President Carlos Perez's official visit to the Gulf countries was scheduled to arrive in Qatar on 21 April, in Kuwait on 23 April, in Saudi Arabia on 25 April, Iran on 27 April, and Iraq on 30 April.

[15] "OPEC Majority " 1.

was successful in that Iran and Iraq announced that they were ready to drop the 5% increase in oil price scheduled for 1 July if corresponding steps were taken by Saudi Arabia and the UAE.[16] On the other hand, Saudi Arabia's seemingly positive attitude towards its oil policy before Fahd's visit to Washington on May 24-25 may have been intended to increase Saudi bargaining power vis-à-vis the US government, allowing it to expect some political rewards in the general direction of some sort of settlement of the Middle Eastern problem.[17] As the Iraqi Oil Minister Tayeh Abd al-Karim stated, "he did not go along with Mr. Yamani's strategy calling for price moderation in order to encourage the United States to pressure Israel into surrendering the occupied areas."[18] Many Arab countries believed that Saudi oil policy in this period was based on the expectation of political rewards from the United States. Without receiving satisfactory political rewards from the United States at the expense of its oil policy, which required the sacrifice of other OPEC members' economic interests, Saudi Arabia was hard put to resist increasing pressure to compromise from other OPEC members.

After confirming the conciliatory decision by the OPEC majority not to increase their scheduled oil prices, Saudi Arabia was obliged to reach a compromise with other OPEC members for the reunification of OPEC's oil prices in July 1977. Given that other OPEC members were ready for price reunification by refraining from increases in their

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[16] "OPEC: Indonesia Confirms Agreement (Iran)," 5-6; "Iraq: Oil Minister Says Iraq is Ready for Price Compromise," *Middle East Economic Survey* XX, no. 34 (June 13, 1977): 3.

[17] "Fahd Says Saudi Arabia Will Meet US Oil Stockpile Needs in Return for Political Efforts towards Mideast Settlement," *Middle East Economic Survey* XX, no. 32 (May 30, 1977): 1-2.

[18] "OPEC: Indonesia Confirms Agreement among Majority to Drop 5% Mid-Year Price Increase (Iraq)," *Middle East Economic Survey* XX, no. 32 (May 30, 1977): 5.

own oil prices by 5%, failure to reach an agreement would have forced Saudi Arabia to shoulder the huge political burden of taking sole responsibility for the two-tier price system. If Saudi Arabia was going to be regarded as inflicting harm on other members of OPEC if it were to pursue an independent oil policy based on moderate prices without any support from other OPEC members,[19] its political stability might be put at risk. In various interviews with the Saudi Crown Prince and First Deputy Prime Minister, Prince Fahd, particularly in April, when production exceeded 10 million b/d, he explained repeatedly that Saudi oil policy was not intended to be inimical harm either to the solidarity of OPEC or to the interests of members.[20] Furthermore, the continuation of a controversial oil policy might also tend to exacerbate divisions within the Saudi administration. In fact, the conciliatory gestures made by other OPEC members gave Saudi Arabia little choice but to raise its oil price 5% to reunify OPEC's oil prices. On June 21, Shaikh Yamani disclosed in an interview with the Jiddah daily *al-Madinah* that he had received a letter from the Venezuelan Oil Minister, notifying him that the eleven OPEC members had decided not to implement the scheduled 5% increase on July 1.[21] In Riyadh a few days later, Saudi Arabia and the UAE issued a statement that the two countries had decided to increase their oil prices by 5% as of July 1, 1977, to reach the level of the other OPEC members' previous increase rate of 10% in light of the

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[19] Even the United Arab Emirates, the only country to follow Saudi Arabia's price moderation at the Doha Conference, did not agree to increase its oil production. See Terzian, *OPEC*, 246-47.

[20] Middle East Petroleum and Economic Publications, "Fahd Warns against Freeze in Mideast Peace Momentum," *Middle East Economic Survey* XX, no. 26 (April 18, 1977): 2; "Saudi Arabia: Saudi Price Moderation," 1-2.

[21] "Yamani Confirms Saudi Arabia Ready to Increase Oil Prices by 5% at Mid-Year Others Freeze," *Middle East Economic Survey* XX, no. 36 (June 27, 1977): 2.

majority's decision not to raise their oil prices.[22] In spite of a compromise 5% increase, Saudi Arabia successfully achieved a degree of price moderation vis-à-vis other OPEC members, and managed to convince them not to make further price increases.

After reaching a compromise between Saudi Arabia and the UAE on the one hand, and the other members of OPEC on oil prices in July 1977 on the other, Saudi Arabia continued its policy of price freeze until the end of 1978. Before the reunification of OPEC's oil prices in July 1977, Saudi Arabia and the United States shared the same opinion on oil prices. In the US Magazine *Business Week*, released on June 17, Shaikh Yamani confirmed his government's intention to raise oil prices by a maximum of 5% on July 1 on condition that the other OPEC members would drop their planned 5% rise. At the same time he hinted that Saudi Arabia would try again to keep prices down in 1978, saying in his interview: "We will have another price battle at the end of 1977."[23] Coincidentally, President Carter mentioned in a televised press conference in Washington on June 30 that he hoped the compromise OPEC prices on July 1 would "hold through 1978 at least."[24] As Carter had hoped, Yamani confirmed to *MEES* at the OPEC Conference in Stockholm that his government's official position was to continue the price freeze until the end of 1978,[25] and Saudi Arabia did in fact succeed in freezing oil prices until the end of 1978. Although there was another disagreement on prices among OPEC

[22] "Saudi Arabia and UAE Align Marker Price with OPEC Majority but Differentials Still out of Line," *Middle East Economic Survey* XX, no. 38 (July 11, 1977): 2.

[23] "Yamani Confirms," 1.

[24] "Saudi Arabia and UAE Align," 2.

[25] "OPEC: The Price Focus Shifts to 1978," *Middle East Economic Survey* XX, no. 39 (July 18, 1977): 1.

members in December 1977, Saudi Arabia was able to reach an agreement on a price freeze with the UAE, Kuwait, Qatar, and Iran. As "the Freeze Front" of five Gulf states accounted for two-thirds of OPEC production, there was little the other OPEC members could do to breach it. [26] Unlike the situation in Doha in 1976, Saudi Arabia was able to secure strong support for a price freeze from some of the most influential OPEC members. With the support of Iran in particular, and given that Iran was hoping to acquire hi-tech weapons from the United States,[27] Saudi Arabia did not have any serious difficulty in continuing its oil policy until late in 1978.

The Reflection of Political Exigencies in Early 1979

Saudi Arabia's oil policy based on moderate oil prices came to be seriously challenged by political events in the Middle East when Egyptian President Anwar al-Sadat and Israeli Prime Minister Menachem Begin signed the Camp David Accords on September 17, 1978. After losing its old Arab partner against Israel, Syria briefly chose Iraq as its new regional partner. During a summit meeting in Baghdad between Presidents Hafiz al-Asad and Ahmad Hasan al-Bakr on October 24-26, they announced the Charter of Joint National Action (*Mithaq al-'Amal al-Qawmi al-Mushtarak*), which agreed on an immediate military union with further Syrian-Iraq unity plans. After the publication of this unity plan, however unrealistic, Saudi Arabia felt that it could not ignore their voices. Initially, Saudi Arabia welcomed the Camp David Accords, but the kingdom changed its position towards Washington and Cairo because of increasing pressure, particularly from

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[26] "OPEC: Price Disagreement Means De Facto Freeze For 1978," *Middle East Economic Survey* XXI, no. 10 (December 26, 1977): 1.

[27] Terzian, *OPEC*, 249-50.

Baghdad and Damascus. Thus at the Baghdad Arab Summit on November 2-5, Saudi Arabia was obliged to join the "rejectionist" camp, distancing itself from both Washington and Cairo.[28] Saudi Arabia also tried to press the US to change its controversial foreign policy in the Middle East based on the Camp David Accords. The official Saudi Radio broadcasted a commentary containing the possibility of using the oil weapon on November 18, saying that, "the oil embargo imposed by the Arabs on those countries which supported Israel during the October 1973 war was, and remains, a reflection of the ability of the Arab world to employ all its capabilities in the service of its cause and to influence events directly."[29] Furthermore, the increasing political instability in Iran in late 1978 encouraged Saudi Arabia to establish closer relations with Iraq, another powerful actor in the Gulf. In this political situation, Iraqi pressure on Saudi Arabia to raise oil prices became increasingly difficult to resist.[30] In an interview with the Kuwaiti daily *al-Siyasah* on October 15, the Iraqi Oil Minister, Tayeh 'Abd al-Karim, made a strong case for a considerable price increase at the upcoming OPEC conference in Abu Dhabi in December and said that his government would start to look for an alternative to OPEC in the case of any further freezes or a merely "symbolic" increase at

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[28] Sonoko Sunayama, *Syria and Saudi Arabia: Collaboration and Conflicts in the Oil Era* (London: Tauris Academic Studies, 2007), 50-54.

[29] Middle East Petroleum and Economic Publications, "Saudi Arabia: Riyadh Radio Hints Oil Weapon May Be Employed Again," *Middle East Economic Survey* XXII, no. 7 (December 4, 1978): 8.

[30] Golub, *When Oil and Politcs Mix*, 29-30.

Abu Dhabi.[31]

Under such strong pressure to increase oil prices, Saudi Arabia was obliged to do so in December 1978. In the course of answering questions after a lecture at the Confederation of Engineering Institutions in London on October 16, Yamani mentioned that a “reasonable” price increase would be made at the OPEC conference in December. At the same time, however, he acknowledged that the current price was generally fair, based on the law of supply and demand. Nonetheless, he justified the price increases as an effort to avoid further increases in the near future, as had happened in 1974.[32] As we will see later in this chapter, Yamani’s justification for an oil price increase in December 1979 seemed to be well grounded. However, without other political exigencies at that time, Saudi Arabia might have delayed this increase. [33] Hence, it is hard to say that this was not political. Furthermore, regardless of the market situation (and even with production cuts in Iran),[34] it was clear that Saudi Arabia was in a position where it needed

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[31] Middle East Petroleum and Economic Publications, "Iraq: Iraqi Oil Minister Warns Iraq Will Seek Alternative to OPEC if December Price Increase is Not Enough," *Middle East Economic Survey* XXII, no. 1 (October 23, 1978): 6.

[32] "Saudi Arabia: Yamani Predicts Reasonable Increase in Oil Prices at Year End," *Middle East Economic Survey* XXII, no. 1 (October 23, 1978): 8.

[33] If Saudi Arabia had already decided to increase oil prices at the OPEC Conference in December to avoid a possible energy crisis without the consideration of the increasing political pressures from Arab oil producing neighbors for the rise in oil prices, it would not have increased its oil production to stabilize the world oil market in the fourth quarter of 1979.

[34] Although spot prices became higher than official OPEC oil prices in the summer of 1978, premiums on OPEC oil in the spot market were relatively small, less than 10 ¢. Even the market situation in late 1976, when it insisted on a price freeze, had made it more attractive for Saudi Arabia to increase oil prices because of the increasing

to conciliate the OPEC price hawks, particularly Iraq, mainly because of the Camp David Accords and the consequent growth in the influence of its radical Arab neighbors. By October, it had already become clear that the principal issue at the conference in Abu Dhabi would not be whether oil prices should be frozen or increased, but how much they should be raised.

Apart from the diminishing negotiating power of Saudi Arabia over its oil policy because of Arab political developments, the reduction of Iranian oil supplies also undermined Saudi Arabia's bargaining power vis-à-vis other OPEC members.[35] The oil market was fairly stable until the third quarter of 1978, and OPEC's official prices and spot prices were almost balanced. Spot market prices had a very limited influence on OPEC's price structure in this period. There were even discounts for OPEC crude oil in the spot market during the first half of 1978.[36] However, the oil market situation was changed dramatically with the Iranian political crisis in late 1978. In the first half of 1978, Iranian crude oil had accounted for 16% of total crude imports in twenty-four OECD

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premiums on OPEC oil in the spot market in the fourth quarter of 1976, with a markup of about 45¢ on some OPEC oil. In addition, Yamani's statement that he intended to increase oil prices at the December Conference was announced before the Iranian crisis, which began with strikes by oil workers on October 20. Therefore, we might conclude that Saudi Arabia's decision to increase oil prices at the OPEC Conference in December was not directly related to the situation of the oil market. See Petroleum & Energy Intelligence Weekly, "What's New around the World: Here's PIW's 10-Year Overview of Spot Crude Oil Prices," *Petroleum Intelligence Weekly* XIX, no. 42 (October 20, 1980): 11; "1980 Spot Price Review for Key World Markets: Special Supplement," *Petroleum Intelligence Weekly* XX, no. 5 (February 2, 1981): 6.

[35] As mentioned above, the oil market situation was a secondary factor leading Saudi Arabia to agree on a price rise at the OPEC Conference in December.

[36] Petroleum & Energy Intelligence Weekly, "What's New: Here's PIW's 10-Year Overview," 11.

nations and about 11% of their total oil supply.[37] Iranian oil production fell to about 1.8-1.5 million b/d from a precrisis 6 million b/d.[38] In this tight market situation, Saudi Arabia tried to prevent supply disruption by increasing its own production, respectively, 9.28 million b/d in October, 10.25 million b/d in November, and 10.40 million b/d in December.[39] As Saudi Arabia acted as a swing producer, it absorbed nearly two-thirds of the Iranian shortfall.[40] Because of the sharp increase in production not only by Saudi Arabia but also by Iraq and Kuwait, total OPEC output slipped only 363,000 b/d to 31.6 million b/d in November over the previous month.[41] Although OPEC output in 1978 was only down 4% from the 1977 record of 31.1 million b/d, marking 29.9 million b/d, the tight market situation became worse at the end of 1978. Iran's oil production continued spiraling down in December, resulting in a 1.1 million b/d drop in total OPEC production in December over the previous month. Even Saudi Arabia's record production in December could not take up all the slack.[42]

Saudi Arabia had no choice but to raise oil prices on December 1978 under the

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[37] "Anxiety Mounts in Consuming States on Iran's Oil Future," *Petroleum Intelligence Weekly* XVIII, no. 4 (January 22, 1979): 8.

[38] Middle East Petroleum and Economic Publications, "Implications of the Iranian Oil Supply Crisis," *Middle East Economic Survey* XXII, no. 3 (November 6, 1978): 2.

[39] Petroleum & Energy Intelligence Weekly, "PIW's Month-by-Month Breakdown of OPEC Crude Oil Production for 1978," *Petroleum Intelligence Weekly* XVIII, no. 5 (January 29, 1979): 9.

[40] "OPEC Output down Just 4% from Record Annual High," *Petroleum Intelligence Weekly* XVIII, no. 5 (January 29, 1979): 1.

[41] "What's New around the World: OPEC Oil Flow Nearly Steady, Despite Iran," *Petroleum Intelligence Weekly* XVIII, no. 1 (January 1, 1979): 11.

[42] "OPEC Output down Just 4%," 1.

growing influence of its radical Arab neighbors and the tight oil market. Iraq, in particular, which had gained great confidence after having acquired much of what it wanted at the Baghdad Arab Summit, put a lot of pressure on Saudi Arabia to join a consensus on an oil price increase. Mr. ‘Abdul-Karim said in an interview with the Kuwait daily *al-Nahdah* in early December, “the spirit of unity which prevailed at the Baghdad Arab Summit will be reflected positively in OPEC’s price deliberations.”[43] In addition, there were reports from Baghdad in early November that “a special joint sub-committee would meet in Damascus on 25 November to discuss the reopening of the oil pipeline system linking Iraq’s northern oil fields with the Mediterranean terminals at Banias in Syria and Tripoli in Lebanon.”[44] The possibility of the reactivation of the oil pipeline between Baghdad and Damascus meant that the amicable relations between these two countries would be strengthened not only in the Arab political arena but also in the economic field, particularly allowing Iraq to raise its voice within OPEC and limiting Saudi Arabia’s bargaining power vis-à-vis other OPEC members. Even moderates like Kuwait and Venezuela, dissatisfied with the depreciation in the value of the US dollar and world inflation, proposed quarterly oil price increases at informal consultations among OPEC members before the conference in Abu Dhabi. The UAE indicated that it would follow Saudi Arabia’s decision, while implying that it would prefer a moderate price increase. Thus on November 20 Yamani clarified Saudi Arabia’s position on oil prices to US Treasury Secretary Blumenthal on his Middle East tour, mentioning that,

[43] Middle East Petroleum and Economic Publications, "Iraq: Iraq Hopeful regarding Consensus on Oil Price Increase," *Middle East Economic Survey* XXII, no. 7 (December 4, 1978): 10.

[44] "Iraq-Syria: Iraq and Syria Discuss Reactivation of Kirkuk-Mediterranean Pipeline," *Middle East Economic Survey* XXII, no. 6 (November 27, 1978): 4.

“the Saudis would be unwilling this time to break ranks with other OPEC member countries and cause a price split of the sort which occurred within OPEC in December 1976.”[45] On the other hand, although Saudi Arabia tried to stabilize oil prices by increasing its oil production to maximum levels in the fourth quarter of 1978, it failed to control increasing spot oil prices and this tight market situation led it to join the price increase in December. Since late 1978 the spot market had drifted out of Saudi Arabia’s control because of the growing concern over supply disruption caused by the continuing crisis in Iran. Prices for Mideast light 34° in the spot market increased, recording $12.85 per barrel in October, $13.2 in November, and $14.5 in December, in comparison with the official OPEC price of $12.7 per a barrel.[46] Eventually, OPEC decided to raise oil prices in Abu Dhabi on December 16-17 by an average of 10% during 1979.[47]

Although Saudi Arabia agreed to increase oil prices at the OPEC conference in December, it continued to try to stabilize the market until January 20, 1979. Saudi oil policy at this time was precarious, trying to maintain a balance between the interests of the US and of its Arab neighbors. It was obliged to join the OPEC majority to increase oil prices, while trying to stabilize the oil market by producing its oil at maximum capacity. After the OPEC Conference, Yamani remarked on December 25, “the 10 million b/d levels Aramco reached in November-December are still below the sustainable capacity of

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[45] "OPEC: Quarterly Oil Price Increases Favored by Kuwait and Venezuela," *Middle East Economic Survey* XXII, no. 6 (November 27, 1978): 1-3.

[46] Petroleum & Energy Intelligence Weekly, "1980 Spot Price Review," 6.

[47] OPEC, *Official Resolutions and Press Releases*, 159-60.

a bit under 12 million b/d."[48] Although its practical operating limit was more likely 10.5-11 million b/d in accordance with analyses by oil experts, Yamani tried to send a positive signal to the oil market that Aramco had more room for further production in an attempt to stabilize the world oil market by mentioning a possible output of 12 million b/d. Aramco continued to produce between 10.2-10.5 million b/d in the first half of January 1979.[49] US Energy Secretary Schlesinger lauded Saudi Arabia for helping to offset the loss of Iranian oil by increasing its own production in this period.[50]

The US tried to show conciliatory gestures toward Saudi Arabia to acquire the kingdom's cooperation. Because of the unfavorable political developments in the Middle East, caused mainly, but not only, by the Camp David Accords, but also by the expansion of Soviet-backed communist influence in Ethiopia and Afghanistan, the incipient conflict between North and South Yemen and the high possibility of the fall of the Shah in Iran, Saudi Arabia might have shown growing dissatisfaction with the US and feared for its own political stability.[51] The US tried to improve its relations with Saudi Arabia through economic cooperation. On November 19, 1978, Saudi Arabia and the US signed three new economic agreements, after a two-day meeting of the Saudi-US joint Commission on Economic Cooperation in Jeddah. The agreements included the development of the Saudi Arabian Agricultural Bank, the supply of US transportation specialists to assist the

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[48] Petroleum & Energy Intelligence Weekly, "Heavy Crude Share Rises as Aramco Output Hits Record," *Petroleum Intelligence Weekly* XVIII, no. 5 (January 29, 1979): 6.

[49] "New Saudi Moves on Supply, Price," 5.

[50] "Schlesinger Warns of Curbs on Oil Use in U.S. by April 1," *Petroleum Intelligence Weekly* XVIII, no. 6 (February 5, 1979): 5.

[51] Golub, *When Oil and Politcs Mix*, 31.

Ministry of Communications and Transport, and the dispatch to the US of thirteen high-ranking government employees to train Saudis in modern administrative techniques.[52] On the other hand, the US tried to relieve Saudi Arabia's anxiety over its security through military cooperation. It agreed to send a squadron of twelve F-15 jets to Saudi Arabia in late January 1979 and an aircraft carrier group was deployed in the vicinity to make a show of force. Military cooperation continued with the arrival of two E-3A Airborne Warning and Control System (AWACS) in March 1979 and by various arms transfers, including F-5 aircraft, to North Yemen, a package mostly financed by Saudi Arabia.[53] However, the fall of Shah and the triumph of the Iranian revolution as well as the continuing conflict in Yemen meant that all these efforts on the part of the US came to nothing for the time being.

In contrast to the expectation that Saudi Arabia would play an important role in stabilizing the oil market by increasing production, the Saudis disappointed the US by deciding to reduce production. On January 20, 1979, it announced that it would increase production by 1 million b/d to a ceiling of 9.5 million b/d monthly average for the first quarter effective from January 1. However, as Aramco's production ranged between 10.2 and 10.5 million b/d in the first half of January, this decision resulted in a virtual reduction in Saudi oil production with sharp cuts (about 8 million b/d) in late January to match the new production ceiling. Furthermore, Saudi Arabia priced 14.5% above the 1978 level instead of the 5% higher price set for the first quarter for the 1 million b/d of

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[52] Middle East Petroleum and Economic Publications, "Saudi Arabia: Saudi Arabia and US Conclude Three Cooperation Agreements," *Middle East Economic Survey* XXII, no. 6 (November 27, 1978): 4-5.

[53] Long, *The United States and Saudi Arabia*, 62.

“new” oil above the 8.5 million level “borrowed” from fourth-quarter 1979 supplies. The decision brought a price of $14.55 for Arab Light maker crude, $1.21 higher than the first quarter price of $13.34.[54] Before Saudi Arabia’s announcement, the prospect for the oil market in 1979 was optimistic. Based on the data reaching the International Energy Agency (IEA) before January 12, the IEA had concluded that the Iranian export cutoff would pose no major problems for the oil market during the winter.[55] However, Saudi Arabia’s announcement that it would cut oil production aggravated what had become a tight market situation. The spot premium on the Arabian Light Marker Crude soared to $4.16/barrel over the official price of $13.34/barrel by the end of January from $1.40/barrel in early January.[56] After the Saudi decision to cut oil production and impose premiums on oil production over 8.5 million b/d, there were subsequent price increases by most OPEC members with feasible excuses for premiums based on the spot market, surcharges, and differentials for the first quarter of 1979; exceptions were Algeria, Nigeria, Indonesia, and Venezuela.[57] As *PIW* concluded, it was Saudi Arabia that started the OPEC price acceleration when it imposed the planned fourth-quarter OPEC price on

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[54] Petroleum & Energy Intelligence Weekly, "New Saudi Moves on Supply, Price," 5-7; "More Aramco Firms Raise Prices and Cut Oil Supplies," *Petroleum Intelligence Weekly* XVIII, no. 7 (February 12, 1979): 2.

[55] "IEA Still Sees No Need to Trigger Oil Sharing Yet," *Petroleum Intelligence Weekly* XVIII, no. 6 (February 5, 1979): 2.

[56] Middle East Petroleum and Economic Publications, "Spot Price Premium Past $4/Barrel Mark," *Middle East Economic Survey* XXII, no. 16 (February 5, 1979): 1.

[57] Petroleum & Energy Intelligence Weekly, "Latest Tally of World Oil Price Increases: Special Supplement," *Petroleum Intelligence Weekly* XVIII, no. 11 (March 12, 1979): 1-2.

its extra oil supply.[58]

Saudi policy encouraged further price rises. At the OPEC Conference on March 26-27, 1979, Saudi Arabia agreed to apply price adjustments to Marker Crude, making its price $ 14.546 in effect from April 1, 1979, instead of the originally scheduled price of $13.85 b/d for the second quarter. At the same time, it allowed other OPEC members to add a market premium to their oil in order to reflect the realities of the world oil market in which spot prices were overwhelming the official OPEC selling price.[59] Seymour described the OPEC decisions as follows: "individual countries are free to impose whatever market premiums or surcharges they may deem justifiable in the light of their own circumstances."[60] Furthermore, on April 9, 1979, Saudi Arabia confirmed that it would cut back its production by 1 million b/d for April to its normal 8.5 million b/d ceiling in spite of the uncertainty over the restoration of Iranian exports.[61] All these Saudi decisions tightened up world oil supplies and encouraged spot prices to soar. In May, spot prices for Mideast Light 34° recorded $34.25 per barrel, almost $20 higher than the official OPEC prices.[62]

The deviation of Saudi oil policy from its long-term economic interests in maximizing oil wealth through price moderation was primarily a reflection of short-term

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[58] "Saudi Moderation on Prices Seen as a Mixed Blessing," *Petroleum Intelligence Weekly* XVIII, no. 15 (April 9, 1979): 1.

[59] OPEC, *Official Resolutions and Press Releases*, 164.

[60] Ian Seymour, "A Multi-Tier Price Structure for OPEC," *Middle East Economic Survey* XXII, no. 24 (April 2, 1979): 1.

[61] Petroleum & Energy Intelligence Weekly, "Saudis' Output Cut Doesn't Help Their Price Moderation," 1.

[62] "1980 Spot Price Review," 8.

political exigencies. In early 1979, Saudi Arabia had two main political concerns, the political unrest in Iran and the conflict in Yemen. The emergence of the Islamic Republic after the Shah's departure on January 16, 1979 compelled it to take action against what it took to be Iranian hostility. As Safran pointed out, the triumph of the revolution turned Iran from a strategic shield to a major threat for the Saudi regime.[63] In February 1979, Khomeini strongly criticized the Shah's oil policy as being against Iranian national interests as follow:

> World capitalism and its affiliate, the Shah's regime, were bent on finishing Iran's oil resources within the next twenty years in order to make possible their own survival. We must bear in mind that by selling independently 40,000,000 tonnes of crude oil by our national and revolutionary government we shall bring to Iran the same revenues which would have been achieved through the sale of 300,000,000 tonnes of oil by the puppet regime.[64]

The Saudi government needed to appease the new Iranian government and tried to show its amicable attitude towards its oil policy, which was of course very different from that of the Shah. On the other hand, as the skirmishes between the YAR (Yemen Arab Republic) and the PDRY (People's Democratic Republic of Yemen) erupted into a full-scale war by February 1979 in spite of Saudi Arabia's attempt to mediate a cease-fire that would bring security to the Saudi southern border, diplomatic cooperation from Iraq and Syria was needed to achieve the cease-fire. On March 6, the two Ba'thist regimes submitted a set of proposals to the Arab League Foreign Ministers to promote the resumption of unity talks between the two Yemens. Both countries also sent warnings to South Yemen not to continue the PDRY's military advances to the heart of YAR territory

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[63] Safran, *Saudi Arabia*, 234.

[64] Ali M. Ansari, *Modern Iran since 1921: The Pahlavis and After* (Harlow: Longmand, 2003), 216.

and supported the Saudi call to stop the PDRY's advance on Ta'izz, the second city of the YAR.[65] After talks between the presidents of the PDRY and the YAR on March 27-31, they reached an agreement to implement the 1972 unity agreement in full.[66] Disappointed by the insufficient US efforts to provide it with adequate regional stability, Saudi Arabia had to rely on the Damascus-Baghdad axis without antagonizing the new Iranian regime. In an interview with an Arab newspaper in London in April, Yamani explained that there was no need for any increase in Saudi production: "Iran has succeeded in raising its production to about 4 million b/d" and mentioned "the desire of certain OPEC members to increase their production to meet any shortage in supply."[67] Given that most OPEC members, particularly Iran, Iraq and Libya, were indulging in price increases in excess of the spot prices, the decision to increase oil prices and to reduce output was political, so as not to antagonize both Iran and neighboring Arab countries.

Saudi Oil Policy in Transition

To understand why signs of political changes in Saudi oil policy became noticeable after May 1979, we need to know first how Saudi Arabia, particularly Yamani, saw the world oil market in the late 1970s. After the triumph at the OPEC Conference in December 1977, Yamani initiated a study on "Long-Term Strategy" for prices, aimed at avoiding any repetition of the upheavals during the 1970s and at establishing a

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[65] Sunayama, *Syria and Saudi Arabia*, 55.

[66] Safran, *Saudi Arabia*, 293.

[67] Petroleum & Energy Intelligence Weekly, "Saudis' Output Cut Doesn't Help Their Price Moderation," 1.

harmonious policy of oil pricing, which would satisfy the economic interests of all OPEC members.[68] At the OPEC ministerial meeting in Ta'if, Saudi Arabia, on May 6-7, 1978, Yamani exchanged ideas with other members on a long-term production strategy for OPEC. At this meeting, Yamani anticipated a critical period of shortfall after the present surplus, which would be followed by a period of balance. He argued that market forces rather than OPEC would determine oil prices when the shortfall arrived.[69] Over two years' experience of a continuous increase in demand after the fall in demand in 1975 because of the high prices resulting from the Arab oil embargo and gradually increasing oil production in non-OPEC countries, particularly the North Sea producers, should have made any anxieties about the rapid replacement of oil by alternative energy sources redundant and unnecessary. Since April 1978, the Saudi officials' main concern had no longer been the development of alternative energy sources but a possible energy crisis in the near future, which would undermine the power of OPEC to control oil prices vis-à-vis the increasing influence of market forces. At the end of the 1970s, there were many analyses anticipating oil shortages in the future, as we shall see in Chapter VIII. As explained already in the section on "Target Revenue" in Chapter VI, there were also growing anxieties about rapid oil depletion in Arab and OPEC countries. The future oil supply shortage-related discourse in the oil industry and in academia in the late 1970s

[68] Terzian, *OPEC*, 251.

[69] Ian Seymour, "OPEC: A New Direction?," *Middle East Economic Survey* XXI, no. 30 (May 15, 1978).

seems to have strengthened Yamani's apprehensions about the future of the oil market.[70] Accordingly, Saudi officials began to press the oil consuming countries to give priority to conservation and the development of alternative energy sources.[71]

Growing concerns about the future at the end of the 1970s led Saudi officials to begin to consider changing their policy from price moderation towards advocating gradual price increases in the near future in order to stave off a possible energy crisis. At a meeting of the Canadian Society of Petroleum Geologists at Calgary on June 26, Yamani argued that oil prices should be permitted to grow gradually in real terms throughout the rest of the century to prevent future energy crises. This would give market forces opportunities to control oil prices instead of OPEC and thus make oil prices volatile.[72] He expressed similar opinions on the future of the oil market in the course of a

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[70] According to Daniel Yergin, Yamani, the leading proponent of the Long-Term Strategy for OPEC, was convinced that there would be a shortage of oil sometime around the mid-1980s. See Yergin, *The Prize*, 672.

[71] Fahd's speech on economic affairs at the meeting of the Board of Governors of the Arab Bank for Economic Development in Africa in Riyadh on April 19, 1979, is a good example. See Middle East Petroleum and Economic Publications, "Fahd Voices Concern over World Economy," *Middle East Economic Survey* XXI, no. 28 (May 1, 1978): 1. According to the dominant firm model, oil conservation and the development of alternative energy sources are not consistent with Saudi Arabia's long-term wealth maximization strategy. However, under a market situation where oil demand was approaching OPEC's production capacity, the Saudi leadership was evidently worried about future supply shortages, which would seriously challenge Saudi Arabia's position as a price setter in the world oil market and increase the influence of market forces over oil prices. According to the dominant producer model, it is a basic and necessary condition for Saudi Arabia to be a price setter in the world oil market. Therefore, the Saudi officials' call for conservation and the development of alternative energy sources, which seemed to deviate from the dominant producer model, should be understood as attempts to achieve Saudi Arabia's long-term economic interests of oil wealth maximization by avoiding possible energy crises in the future.

[72] Ahmad Zaki Yamani, "The Changing Pattern of World Oil Supplies," ibid.Supplement to XXI, no. 39 (July 17, 1978): 1-6.

discussion on oil broadcast by French television on November 14, 1978.[73] Perhaps Yamani should have envisaged small price increases at some point in the end of the 1970s or in the early 1980s. However, as mentioned earlier in this chapter, it is doubtful that Saudi Arabia's concerns about the future of the oil market were directly related to the price increases made at the OPEC Conference in Abu Dhabi. In the historical circumstances of late 1978, it is highly possible that political exigencies encouraged Saudi Arabia to agree to price increases by advancing the date of the implementation of the regular, small increases in price that Yamani envisaged. However, Saudi oil polices based purely on political considerations in early 1979, very far from Yamani's Long-Term Strategy for OPEC, pushed the world oil market out of OPEC's control, and began to allow market forces to lead oil prices to an unexpected extent.

Disenchanted with Saudi Arabia's limited role in the world oil market early in 1979, the US began to implement its market oriented oil policy in April. As will be explained in Chapter VIII, on April 5, 1979, President Jimmy Carter announced the phasing out of fixed oil prices effective June 1, 1979, which had been delayed during the first quarter because of the tight market situation caused by the disruption in Iranian supply. In April, the US had begun to understand that Saudi Arabia would only be able to play a limited role in the stabilization of the world oil market in the future. A staff report entitled "The Future of Saudi Arabian Oil Production" prepared by the Subcommittee on International Economic Policy of the Senate Foreign Relations Committee in April 1979 was pessimistic about Saudi Arabia's capacity to implement oil production above 12 million b/d. It also estimated that limitation of Saudi oil output to 12 million b/d could

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[73] Middle East Petroleum and Economic Publications, "Yamani on French Television," ibid.XXII, no. 7 (December 4, 1978): i-iii.

result in the possibility of demand exceeding supply by anything between 1 million b/d and 11 million b/d by 1990.[74] US officials began to issue statements implying that market forces would take over the world oil market at the expense of OPEC's power to control prices. In a statement by Energy Secretary Schlesinger in April, he opined: "OPEC's role is now less than it was earlier because market forces have largely taken over." A few days later, on April 26, he told journalists that OPEC "market premiums" would prevail in a few months and Saudi Arabia would have to choose either to increase oil prices or adopt the "market premiums" imposed by other OPEC members.[75] After April 1979, the US seemed to be moving toward a market oriented oil policy for the world oil market, which it considered a useful means of gradually taking the stabilization of world oil prices out of the unreliable and erratic hands of OPEC.

During this period, Saudi Arabia was exposed to the increasing influence of market forces. This threatened OPEC's price unification and thus its role as a price setter in the world oil market, the primary condition for its long-term economic interests. After the OPEC Conference in March, which brought increases in OPEC's official prices in effect from 1st April 1979 and the free application of market premiums or surcharges to all OPEC crude, spot crude prices became uncontrollable. Mideast Light 34° skyrocketed from $20.30 in March to $34.25 a barrel in May. Mideast Heavy 31° jumped from $19.80 in March to $29.20 a barrel in May, and African Light 27/44° soared from $23.25 in

[74] "Saudi Arabia: Consumers Should Not Expect Big Rises in Saudi Output in 1980s, Says Senate Committee Report," *Middle East Economic Survey* XXII, no. 27 (April 23, 1979): 7.

[75] Terzian, *OPEC*, 267.

March to $32.75 a barrel in May.[76] While Saudi Arabia abided by OPEC's official prices, other OPEC members increased their oil prices by applying additional surcharges to their crudes. For example, Kuwait escalated its surcharges from $1.20 to $1.80 a barrel in early April and Iran followed suit by increasing its surcharges from $1.80 to 1.90 a barrel. The situation deteriorated when three key producers – Libya, Abu Dhabi and Venezuela – increased their oil prices by another 60¢ to 80¢ a barrel in mid-May. They justified these increases as "modest" in the context of the prices cited on the spot market. They even tried to sell more oil on the spot market at prices above $30.[77] OPEC's whole price structure drifted out of Saudi Arabia's control, widening the gap between "lower tier" Saudi Arabia and other "upper tier" OPEC producers.

Therefore, signs of changes in Saudi oil policy were obvious after May 1979 with the gradual awareness that market forces had begun to take over Saudi Arabia's key role in controlling oil prices. Saudi Arabia decided to try to reduce its transactions on the spot market and to expand its participation in oil exports. It changed its oil export policy in May by providing the four US partners in Aramco with less Saudi supply and by increasing its direct crude oil sales under new state-to-state deals with a variety of countries in an attempt to reduce reliance on US firms and their world marketing networks and to take on a more aggressive and direct export role in order to bring about

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[76] Petroleum & Energy Intelligence Weekly, "The ABCs of Measuring Oil Market Price Trends: Special Supplement," *Petroleum Intelligence Weekly* XXI, no. 10 (March 8, 1982): 8.

[77] "Price Surcharges Soar on Heavier Mideast Crude Oils," *Petroleum Intelligence Weekly* XVIII, no. 16 (April 16, 1979): 1-2; "Iranian Sales Terms Emerge as New Deals are Signed," *Petroleum Intelligence Weekly* XVIII, no. 16 (April 16, 1979): 9; "More OPEC States Raise Prices Again, Others May Follow," *Petroleum Intelligence Weekly* XVIII, no. 21 (May 21, 1979): 3.

greater stability in marketing their oil. The decision immediately led many refiners, who had failed to secure supplies from the major oil companies due to their force majeure cutbacks and reduced third-party sales, to rush into the spot market in desperation, although the fact that Petromin was selling more oil directly could offset this trend.[78] In terms of all Petromin's direct sale contracts, there was a clause that prohibited the payment of any commissions to intermediaries, and added that if any buyer of Saudi crude or products were to break this agreement Petromin would have the right to cancel the contract. Furthermore, Taher also stated that "Petromin's contracts prohibit the resale of Petromin-supplied crude to third parties and stipulate that products derived from such direct crude supplies should not be re-exported to third countries."[79] Saudi government regarded its increasing role in exporting its oil on the world market as an effective way of discouraging the increasing tendency on the part of the major international oil companies to trade crude oil on the spot market.

Saudi Arabia also intimated that it would take further steps to reunify OPEC's

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[78] "Saudi Shift to More Direct Sales Means Less Oil for U.S.," *Petroelum Intelligence Weekly* XVIII, no. 20 (May 14, 1979): 2-3; According to Petromin governor Dr. Taher in October 1979, Saudi Arabia's total direct exports of crude oil had grown to some 1.3 million to 1.4 million barrels daily. He declined to give a precise figure for the Saudis' increasing state-to-state sales, but *PIW* estimated that they were approximately 1 million b/d of total exports. Because of rising direct sales of Saudi Arabian crude oil by Petromin, the US Aramco partners' allocation went down to its lowest level of 6.55 million b/d in June 1980 since the government had allowed Aramco production to rise temporarily to 9.5 million b/d in July 1979. Thereafter, direct crude oil sales by Petromin exceeded 2 million barrels daily for the first time in July 1980. See "Saudi State-to-State Oil Sales Now at 1-Million B/D," *Petroleum Intelligence Weekly* XVIII, no. 44 (October 29, 1979): 1; "Aramco Partners Losing Supply as Saudi Sales Rise," *Petroleum Intelligence Weekly* XIX, no. 23 (June 9, 1980): 1; "Saudi Arabia's Direct Crude Sales Top 2-Million B/D," *Petroleum Intelligence Weekly* XIX, no. 31 (August 4, 1980): 7.

[79] Middle East Petroleum and Economic Publications, "Saudi Arabia: Petromin Direct Crude Oil Sales Rise to 1.7 Million B/D," *Middle East Economic Survey* XXIV, no. 10 (December 22, 1980): 6-7.

prices, the primary condition for the restoration of its role as a price setter in the world oil market. After a meeting of the Council of Ministers on May 22, the Saudi Minister of Information announced that his country was studying a proposal to reunify the OPEC oil price structure in order to stop the bidding up of oil prices on the spot market. The statement implicitly indicated that Saudi Arabia was willing to increase its Marker Crude price to achieve a unified OPEC price structure that would exclude the imposition of individual surcharges by other OPEC members.[80] Furthermore, at the end of May, it was clear that Saudi Arabia was contemplating a further step towards OPEC's price unification and the discouragement of spot market transactions by increasing its own output. In an interview with Karen House of the *Wall Street Journal* on May 31, Dr. Taher, Governor of Petromin, also indicated that Saudi Arabia might increase its output effective July 1 in order to achieve the goal of reaching a unified price and have an absolute minimum of oil sold on the spot market.[81]

As oil policies based on political considerations began to act as a serious challenge to Saudi Arabia's long-term economic interests in the maximization of its oil wealth in early 1979, Saudi policy-makers began to realize that it would be necessary to abandon such policies. High and volatile oil prices, with the increasing activities of market forces that were actually being promoted by Saudi Arabia's economically illogical oil policy, necessarily undermined its role as a price controller in the world oil market by threatening OPEC's price structure at the end of May. As Yamani

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[80] "Saudi Arabia: Saudis Contemplating Reunification of OPEC Price Structure," *Middle East Economic Survey* XXII, no. 32 (May 28, 1979): 8.

[81] "Saudi Arabia: Taher Says Saudi Arabia Will Probably Increase Production as Part of Price Stabilization Effort," *Middle East Economic Survey* XXII, no. 33 (June 4, 1979): 8.

acknowledged in an interview with French Television on May 31, market forces had compelled Saudi Arabia to raise oil prices.[82] Oil prices had already drifted out of its control, mainly because of its politically motivated oil policy in early 1979. In early June, there were continuous and growing pressures from the so-called radical Arab oil producing countries such as Iraq and Libya to use the oil weapon against hostile foreign states, particularly the US.[83] However, Saudi Arabia had begun to realize that any further continuation of its politically dominated oil policy would seriously harm its long-term economic interests. In an interview with the Saudi daily *al-Jazirah* on June 3, Yamani affirmed that Saudi Arabia had no intention of lowering its oil production as part of a general Arab strategy to put pressure on Western countries to bring about a comprehensive settlement of the Arab-Israeli conflict.[84]

Soaring oil prices led by market forces put great pressure on Saudi Arabia to increase its official prices to maintain Saudi oil as the Marker Crude within OPEC before the OPEC Conference in June. In May, Algeria all but discarded Saudi Arabian light oil as the standard OPEC marker pricing base, because most Gulf crudes were price-related to a new *de facto* Marker Crude of at least $17 a barrel in May, $2.45 higher than the OPEC official $14.546 marker price. The possibility of Algeria returning to a notional marker price depended on how much Saudi Arabia would realign its prices upward with

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[82] "Saudi Arabia: Yamani Predicts Deep Economic Depression Unless West Reduces Consumption," *Middle East Economic Survey* XXII, no. 34 (June 11, 1979): 5-6.

[83] See "Iraq: Oil Minister Threatens Arab States Who Dissociate Themselves from Baghdad Consensus," *Middle East Economic Survey* XXII, no. 35 (June 18, 1979): 4-5; "Qadafi Threatens Embargo on Oil Exports to US," *Middle East Economic Survey* XXII, no. 35 (June 18, 1979): 5-6.

[84] "Sadui Arabia: Yamani Says Oil Output Will Not Be Used as a Political Lever," *Middle East Economic Survey* XXII, no. 34 (June 11, 1979): 7.

the other OPEC members at the upcoming OPEC Conference in Geneva.[85] To maintain its position as a price setter through OPEC, Saudi Arabia was obliged to join those seeking price adjustments at the OPEC Conference in Geneva on June 26-28, 1979. As a result, OPEC set the Marker Crude at $18 per barrel and allowed members to add a maximum market premium of $2 per barrel to their crudes.[86] This decision was a great disappointment to the oil consuming countries, and many oil specialists took a pessimistic view of Saudi oil policy. Ironically the biggest price rise came from Saudi Arabia, narrowing the spread between the basic Saudi “marker” crude price and OPEC’s highest-priced crudes from the earlier $6.76 level to $5.50 a barrel. The cumulative increase since December 1978 added up to a staggering 70% plus for a number of major OPEC crudes.[87]

Although the oil consuming countries were disappointed with the price agreement at the OPEC Conference in Geneva and were still suspicious of Saudi oil policy, Saudi Arabia did what it could do for its long-term economic interests given its weakened bargaining power vis-à-vis the other members of OPEC, gradually dissociating itself from the Damascus-Baghdad axis in its oil policy. Unlike the situation in 1977, Saudi Arabia’s bargaining power vis-à-vis other OPEC members had become quite limited and it could not effectively hold the lid on prices, because the almost unrestricted influence of market forces had led prices to soar upwards in a tight market and Saudi

[85] Petroleum & Energy Intelligence Weekly, "Algeria Discards OPEC Marker as Price Base for Now," *Petroleum Intelligence Weekly* XVIII, no. 22 (May 28, 1979): 3.

[86] OPEC, *Official Resolutions and Press Releases*, 165.

[87] Petroleum & Energy Intelligence Weekly, "New OPEC System Seen as Blueprint for Price Chaos," *Petroleum Intelligence Weekly* XVIII, no. 27 (July 2, 1979): 1-2.

Arabia's oil production was not high enough to fill the remaining Iranian supply gap and to hold down pressures for price increases. [88] Thus Saudi Arabia had no option but to increase its official oil prices to achieve price unity within OPEC, the necessary condition for putting Saudi Arabia's oil policy into its normal orbit as a price setter. *MEES* news editor Ian Seymour made cynical remarks on the outcome of the OPEC Conference in June, describing "Not an ideal solution, not by any means a unified price, but at least better than the previous free-for-all."[89] However, OPEC's resolution was not completely disappointing, because it also decided that the maximum prices charged by its members should not exceed $23.5 per barrel with the consideration of differentials and market premium. As Terzian pointed out, "imposing a ceiling price of $23.5 a barrel on all OPEC oil was quite a development, because OPEC not only refrained themselves from raising oil prices, but also tried to hold them down by imposing a "ceiling."[90] In an interview on BBC Television on June 20, just before the OPEC Conference, Yamani also declared that his government would make an effort to achieve price moderation against the price hawks at the upcoming OPEC Conference.[91] However, during this meeting, when Iran, Iraq and Libya pressed for a special price-rise session in late September, Yamani stated that he would refuse to attend. Furthermore, in an effort to stabilize the

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[88] "Spot Oil Values Outpace OPEC's Upper-Tier Prices," *Petroleum Intelligence Weekly* XVIII, no. 18 (April 30, 1979): 3.

[89] Ian Seymour, "OPEC Clamps $23.50/Barrel Ceiling on Oil Prices: MEES News Editor Ian Seymour Reports from Geneva," *Middle East Economic Survey* XXII, no. 37 (July 2, 1979): 1.

[90] Terzian, *OPEC*, 269.

[91] Middle East Petroleum and Economic Publications, "Saudi Arabia: Yamani Warns of Energy Disaster Unless Steps are Taken Now," *Middle East Economic Survey* XXII, no. 36 (June 25, 1979): 6.

global oil market psychologically, he also announced that a new construction program was underway that would raise production capacity to 14 million b/d.[92] Therefore, it is hard to say that Saudi Arabia had completely deviated from its traditional oil policy of pursuing moderate oil prices at that time.

Regardless of the fact that the oil market situation led Saudi Arabia to raise its official oil prices in June, the country's decision could be also understood as a strategy of restoring its role as a price setter through the reunification of OPEC's oil prices. To regulate oil prices among OPEC members, it was inevitable that the Saudi government should try to minimize the influence of market forces while stabilizing the world oil market. In this regard, it had already decided to expand its direct oil exports to other oil consuming countries in May by restricting the amount of oil available for the major US oil companies, as mentioned earlier. The idea was that less Saudi oil should be traded on the spot market by reducing the major oil companies' supplies of redundant oil. As a next step to check the growing market pressures for OPEC's price unification in a tight market, Saudi Arabia tried to limit the transactions of other OPEC members' crudes on the spot market by increasing its official oil prices at the OPEC Conference in June. If the price gap between the official prices and spot prices had widened more, it was clear that the other OPEC members would have sold more crudes at spot prices, which would have seriously undermined the position of Arabian Light 34° API as the Marker Crude within OPEC. By reducing the gap between OPEC's official oil prices and spot prices, Saudi Arabia tried to discourage other OPEC members from resorting to transactions on the

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[92] Petroleum & Energy Intelligence Weekly, "OPEC Hopes Prices Will Hold at Least through 3rd Quarter," *Petroleum Intelligence Weekly* XVIII, no. 27 (July 2, 1979): 3.

spot market by restraining spot trades between producers and consumers, which would help it to achieve price unity within OPEC. At the same time, by imposing high oil prices, Saudi Arabia could expect that the consuming countries would resort to more conservative practices vis-à-vis their excessive consumption of oil. As Yamani was already envisaging a future energy crisis in the middle 1980s that would hand over the power of price control to market forces, the decision could also help prevent a possible energy crisis and maintain Saudi Arabia's position as a price setter in the mid- or long-term. He and his colleagues believed that conservative consumption in the oil consuming countries would help tranquilize the increasing demand for oil and consequently lessen consumers' worries about supply disruption. They must have believed that this psychological effect on the oil consuming countries could help mollify oil consumers' panicking into buying at illogically high and volatile oil prices mainly agitated by profit-seeking market forces as well as encouraging OPEC members to abide by the organization's own price structure.[93]

As the maneuverability of Saudi oil policy was very limited in the middle of 1979, the Saudis were not greatly satisfied with the partial agreement on oil prices reached in the OPEC Conference in late June. As seen in *MEES*' analysis of the OPEC Conference in Geneva, "both Iran and Libya declared ominously that in their interpretation the price agreement rested on a tacit implication that no member country

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[93] From a political perspective, the continuation of relatively low Saudi oil prices vis-à-vis other OPEC members' oil prices would have put an immense political burden on the Saudi regime, encouraging internal dissatisfactions and discords as had happened in 1977.

would raise its production to any substantial degree."[94] In addition to these two countries, Iraq also warned that this price unity would not be abided by if any OPEC member substantially boosted output.[95] Under great pressure from other OPEC members not to increase Saudi Arabia's output, it would be difficult for the Saudis to increase production at the same time as trying to achieve price unity within OPEC. However, as Saudi Arabia spread rumors of possible production increases, which did not in fact materialize, it was able to reach a partial agreement on oil prices with other OPEC members. As *PIW* analyzed, "Possibilities of raising Saudi production maybe as much as 1-million barrels daily, as put about in copious pre-meeting hints, were seen in Geneva as an attempt to gain leverage for conference bargaining."[96] Although Saudi Arabia failed to achieve full price unity within OPEC, it could at least impose a ceiling on the prices of OPEC crude that would go some way to restoring its ability to control oil prices.

High Production at High Oil Prices

Between July 1979 and late 1981, Saudi oil policy could be characterized as promoting high oil prices alongside high production in an effort to recover its role as a price setter through OPEC in the world oil market while trying to slow the growing influence of market forces over oil prices. The ambivalent behavior of Saudi oil policy decision-makers in this period led many of those studying Saudi oil policy to reach different conclusions and caused a degree of confusion with the general principles of

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[94] Seymour, "OPEC Clamps $23.50/Barrel Ceiling," 2.

[95] Petroleum & Energy Intelligence Weekly, "OPEC Hopes Prices Will Hold," 3.

[96] "OPEC to Weigh a $20 Ceiling Plus Quarterly Rises," *Petroleum Intelligence Weekly* XVIII, no. 26 (June 25, 1979): 2.

Saudi oil policy. For instance, Golub and Quandt, who focused on Saudi Arabia's attempts to stabilize the international oil market by increasing oil production, argue that its oil policy in this period reflected its own political and economic interests (or political interests alone), which were based on moderate oil prices, without any plausible explanations for why it kept agreeing to price rises.[97] Others, including Adelman and Shwadran, concentrating on the fact that Saudi Arabia always agreed with other OPEC members to increase its oil prices in this period, describe Saudi Arabia as a greedy country attempting to maximize its oil revenues by pursuing high prices. However, they failed to explain why it tried to stabilize the global oil market by increasing production to almost maximal levels. If the Saudi government really wanted to maximize its oil revenues, a small production cut would have given it greater profits in a tight market

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[97] David Golub has explained that Saudi Arabia was obliged to join in the general increase in prices mainly because of much higher spot prices caused by stockpiling by the oil consuming countries. He regarded Saudi oil policy in this period as reactive to market situations, but he failed to analyze its essence, long-term economic interests of oil wealth maximization. As a proponent of political explanations of Saudi oil policy, focusing on Saudi Arabia's relationship with the US, he describes its oil policy after the July 1979 production increase somewhat ambiguously as follows:

> By increasing production levels in July 1979 the regime agreed to disagree with the United States on how to solve the Middle East problem. Not only did this change in policy constitute a kind of half-acceptance of the Egyptian-Israeli peace treaty, it also partially depoliticized Saudi oil policy.

However, Saudi oil policy after July 1979 was not really a reflection of the state's political interests based on amicable relation with the US, but it was implemented in pursuit of the country's own long-term economic and political interests, given the changing regional political environments. When Saudi Arabia implemented oil policy in the early 1980s based on its long-term economic interests by increasing production to stabilize the world oil market, which also satisfied US interests, Saudi officials continued to press the US government to initiate new steps towards a settlement of the Arab-Israeli conflict. Saudi oil policy in this period will be further discussed later in this chapter. See Golub, *When Oil and Politcs Mix*, 43; Middle East Petroleum and Economic Publications, "Yamani Hopes for New US Initiative in Mideast," *Middle East Economic Survey* XXIV, no. 32 (May 25, 1981): i-vii.

situation, while conserving its valuable resources. Therefore, it is really hard to understand the behavior of Saudi decision-makers in this period without understanding the basic principles of Saudi oil policy.

The increasing activities of market forces in the world oil market seriously challenged Saudi Arabia's long-term economic interests in the mid-1979, requiring the abandoment of an economically illogical oil policy. As explained earlier in this chapter, it is clear that it had generally tried to implement its oil policy based on long-term economic interests in maximizing its oil wealth by advocating moderate prices since December 1976. However, in late 1978 and early 1979, the political environment in the Middle East gave market forces strong incentives to take control of oil prices and this negative development was accelerated by Saudi oil policy.

In the process of revitalizing the kingdom's now less firm role as a price setter through OPEC in the world oil market, the priority of Saudi oil policy was to reunify OPEC's oil prices. To achieve price unity within OPEC, Saudi Arabia tried to stabilize the volatile oil market by reducing the increasing influence of market forces over oil prices. In this regard, it was obliged to agree to increase its official oil prices together with the other members of OPEC to reunify OPEC's prices in order to limit the maneuverability of market forces on the world oil market, while it continued to produce its own oil at almost maximum capacity. Therefore, an apparently contradictory oil policy in this period could be understood as a series of attempts to recover Saudi Arabia's role as a price setter in the world oil market by achieving price unity within OPEC.

As Yamani mentioned, "I think we will do our best to move from one stage to another stage"[98]; Saudi Arabia wanted to implement its strategy for price unity within OPEC through a more gradual approach to stabilizing the world oil market. As mentioned earlier in this chapter, the kingdom had agreed to increase its official oil prices with other OPEC members in late June. In spite of the imposition of a ceiling on OPEC crudes, Saudi Arabia largely failed to reach a full agreement for price unity at the OPEC Conference in late June. Therefore, it took the next step towards establishing OPEC price unity by increasing its output in July, reflecting the changing political environment at the regional level. Although Saudi Arabia did not give any indication of the amount of oil involved nor the duration of the temporary increase, it was generally acknowledged that it would raise its output up to 1 million b/d from 8.5 million b/d to 9.5 million b/d for the third quarter of 1979. The official reason for this increase was to generate funds for internal development projects, although this was probably just an attempt to avoid antagonizing the other OPEC members.[99] Given that Saudi Arabia was producing more oil than it did in 1978, with over 40% higher oil prices over 1978 Marker Crude price, the budgetary needs of the Saudi government were unlikely to be the real reasons behind the decision to increase output. In fact, Yamani intimated a few months later that Saudi Arabia was producing more than its budgetary needs at a news conference in Atlanta, Georgia, on October 20, referring to a "Young Turk Mafia" within the Saudi government that was in favor of reducing oil production to a level more consistent with the kingdom's

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[98] "Saudi Arabia: Yamani Warns of Energy Disaster," 6.

[99] "Saudi Arabia Boosts Thrid-Qarter Output by 1 Million B/D," *Middle East Economic Survey* XXII, no. 38 (July 9, 1979).

financial needs and raising oil prices in line with those of other OPEC countries.[100] Speaking to the Jordanian daily *al-Rai* on November 12, 1979, Prince ‘Abdullah more or less admitted that his country was producing more oil than its financial needs for economic development. He said that this policy was based on three principles: preventing the collapse of the world economy, combating inflation, and avoiding a rift within OPEC.[101] While the first two reasons were trite justifications of current Saudi oil policy, the latter seemed to hint at the real reason why Saudi Arabia produced more oil than it needed, given that the play of market forces was severely undermining OPEC’s price unity. It was very likely that the decision in July to increase output would have originated from an additional attempt to stabilize the world oil market, by discouraging the activities of market forces and facilitating the reunification of OPEC’s oil prices. While the decision to increase official prices in June was a passive step designed to achieve price unity within OPEC, the decision to increase output in July was a much more proactive measure.

What made Saudi Arabia become more active in implementing an oil policy based on its long-term economic interests? Although Golub argues that the internal and external political factors were the main reasons for the changes in policy in July, his analysis should be reconsidered based on the relations among these political factors. He considered that there might well have been differences and divisions within the royal family over the Camp David Accords and these problems may well explain the Saudi

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[100] "Saudi Arabia: Confusion regarding Differences over Production and Prices in Saudi Arabia," *Middle East Economic Survey* XXIII, no. 2 (October 29, 1979): 6.

[101] "Saudi Arabia: Prince 'Abd Allah Says Saudi Oil Production Will Continue to Exceed Development Needs," *Middle East Economic Survey* XXIII, no. 5 (November 19, 1979): 6.

government's decision to deviate from its traditional policy during the first half of 1979. In his explanation, in addition to the reduction in external political pressures particularly from Iraq and Syria because of the failure of the unity talks in June 19, a compromise over these disagreements allowed the Saudi government to implement its traditional oil policy in mid-1979.[102] However, his argument does not quite explain the primary reason that led Saudi oil policy away from its traditional strategy in early 1979. It was not the Camp David Accords itself, but the increasing pressure from the neighboring countries that caused the internal divisions regarding the peace treaty. As mentioned earlier, Saudi Arabia initially welcomed the Camp David Accords, but it was obliged to change its position toward the peace treaty because of the increasing influences of the radical Arab countries in Middle East politics. If there were no political exigencies exposed by the radial Arab neighbors' increasing political posturing, combined with the threat posed by the emergence of the Islamic Revolutionary regime in Iran, Saudi Arabia would have kept implementing its traditional oil policy. As internal disagreements were largely sparked by increasing political pressure from Saudi Arabia's radical Arab neighbors, this domestic political factor could not be the primary reason for the changes in its foreign and oil policies. Saudi Arabia could easily compose its internal differences in favor of the pro-American faction led by Fahd in late June, when it was relatively free from the radical voices of the neighboring countries because its long-term economic and political interests were closely related to cooperation with the United States. Therefore, it was not domestic political factors but the changing political environment in the region that directly contributed to changes in Saudi oil policy. As long as Saudi Arabia was not

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[102] For details, see Golub, *When Oil and Politcs Mix*, 39-42.

seriously exposed to political threats, there was no reason for its leaders to be divided over their oil policy[103] and thereafter to implement a policy that deviated from its long-term economic interests and which would considerably undermine its long-term political interests by alienating its relations with the West, particularly the US.

The regional political environment in the Middle East during the summer of 1979 enabled Saudi Arabia to set its traditional oil policy in an active way. As could easily have been anticipated, four days of talks in Baghdad, from June 16-19, between Iraqi President Ahmad Hasan al-Bakr and Syrian President Hafiz al-Asad finally failed to achieve a complete union between the two states, ostensibly because of Syria's and Iraq's different attitudes toward the Iranian Revolution. While Syria fervently supported the Revolutionary Iranian government, Iraq regarded it as a potential threat to the Iraqi regime and tried to destabilize it. Thereafter, their different political positions towards Iran led both Syria and Iraq to revert to their "normal" position of mutual hostility.[104] The disruption of the potentially influential Damascus-Baghdad axis allowed Saudi Arabia to increase its maneuverability both in its foreign and its oil policies, since it was no longer going to be vulnerable to political pressure from its neighbors. In addition, Khomeini and the new provisional government were facing internal challenges over the Iranian referendum the following spring. Groups such as the NDF (National Democratic Front),

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[103] There is one exceptional case that caused the internal differences regarding traditional Saudi oil policy without any political exigencies: in 1977, when Saudi Arabia pursued its traditional oil policy by increasing production at relatively low prices in comparison with other OPEC members to achieve price unity within OPEC. The extent of over-production caused fires and technical problems in the oil fields.

[104] Middle East Petroleum and Economic Publications, "Iraq-Syria: Iraq and Syria Set up Unified Political and Military Commands," *Middle East Economic Survey* XXII, no. 36 (June 25, 1979): 10; Safran, *Saudi Arabia*, 55.

the Fedayin (usually called the Marxist Fedayin) and the Kurdish groups not only boycotted the referendum but turned to open revolt, and there was also unrest among the Arabs of Khuzestan and in Baluchistan. On May 30, Arab dissidents were involved in a clash with progovernment forces and it was reported that between 100 and 200 people were killed. Pipeline explosions in Khuzestan in July were also believed to be sabotage on the part of these Arab dissidents and the chairman of the National Iranian Oil Company (NIOC) called for the dispatch of 1,000 troops to protect vital oil installations in Khuzestan. The main concerns of Iranian politicians were to preserve the territorial integrity of the country and to concentrate on the political struggle in Tehran at that time. Particularly in Khuzestan, the Teheran government blamed Iraq, believing that Baghdad was smuggling arms and ammunition to the region and thus rendering attempts to disarm the Arabs unsuccessful.[105] By June 1979 relations between Iran and Iraq had deteriorated to outright expressions of mutual hostility, including open attempts at mutual subversion and border skirmishing.[106] This deterioration of relations between Iraq and both Syria and Iran encouraged Iraq to cooperate with Saudi Arabia in various fields. Under such circumstances, Saudi Arabia was relatively free from external political influences and could easily return to its traditional oil policy without serious regional opposition.

By taking advantage of the changing political environment in the Middle East, Saudi Arabia decided to propose a Middle East peace initiative of its own, which would ensure the political security of the Āl Saʻud in the long run. With no solution to the Arab-

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[105] Michael Axworthy, *Revolutionary Iran: A Histroy of the Islamic Republic* (Oxford: Oxford University Press, 2013), 154-55; Middle East Petroleum and Economic Publications, "Iran: Pipeline Explosions Cut Abadan Refinery Throughput," *Middle East Economic Survey* XXII, no. 39 (July 16, 1979): 1-2.

[106] Safran, *Saudi Arabia*, 355.

Israeli conflict in sight, it was clear that Saudi Arabia would not be free from pressure from its more radical Arab neighbors and its security could not be guaranteed in the long-term. All these negative effects of the Arab-Israeli conflict also limited Saudi Arabia's capacity to set its oil policy based on its own long-term economic interests, which would also satisfy its long-term political interests. In an effort to guarantee these political interests, particularly the political security of the Āl Sa‘ud based on cooperation with the US, Saudi Arabia decided to pursues its own initiative for a Middle East peace treaty, while acknowledging differences between Saudi Arabia and the US over the Egyptian-Israeli peace treaty. In late June, the changing regional political environment gave the Saudi government a good opportunity to dominate the discourse regarding a peace settlement in the Middle East. On June 21, 1979, Fahd made a statement containing the formula for reconciliation with the US. At the same time, he also urged the US to begin a dialogue with the Palestine Liberation Organization (PLO) on the basis of the PLO accepting a modified version of UN Resolution 242, on which, Fahd implied, he had already obtained the agreement of the PLO.[107]

The Saudi government must have expected that this decision would contribute to deflecting criticisms from neighboring countries on their reverting to their traditional oil policy. Although Fahd's proposal failed to secure support from the Arab states and raised opposition from both Egypt and Israel in spite of the Carter administration's efforts to support it, the proposal at least gave the rest of the Arab world the sense that Saudi Arabia was pursuing its own independent peace negotiations in the Middle East irrespective of the influence of the US. This must have contributed to diluting the doubts

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[107] Ibid., 405.

felt by the rest of the Arab world that Saudi Arabia shared stronger economic and political interests with the US than with the Arab states in various fields, including its oil policy. Whether or not Fahd expected that his peace initiative would be acceptable to the various parties, he could successfully secure greater maneuverability in oil policy by proposing his own peace initiative. This gesture provided the Saudis with increasing autonomy in oil policy, alleviating criticism from the rest of the Arab world on the return of Saudi oil policy to its traditional path, which was based on the country's long-term economic interests.

As Saudi Arabia returned to its traditional oil policy, it also expected some political rewards from the US. As a reconciliatory gesture to attract US support for Fahd's peace initiative, Yamani refrained from blaming the Americans for the deteriorating market situation caused by the volatile prices in the spot market in an interview on BBC Television on June 20, saying, "I think the Americans behaved much better than some other nations. They refrained from the spot market for a while, I think there are some nations here, in Europe."[108] This statement was quite different from the previous positions of Yamani who openly had blamed the negative effects of the activities of independent American oil companies on the spot market. By showing an amicable but still cautious attitude toward the US, Saudi Arabia probably expected American support for Fahd's peace initiative. In term of its decision to increase its output in July, *PIW* also guessed that there might have been a political decision involving some quid pro quo with the Carter Administration on Washington's pivotal role in the Middle East peace talks. President Carter's sudden unexplained cancellation of a major energy

[108] Middle East Petroleum and Economic Publications, "Saudi Arabia: Yamani Warns of Energy Disaster," 7.

address scheduled on July 5 might have been the outcome of a political deal between Saudi Arabia and the US involving Saudi oil policy.[109] In addition, the Carter Administration announced in July its intention to support congressional approval for a $1.2 billion package that would continue the modernization of the Saudi National Guard.[110] After giving up trying to persuade Saudi Arabia to support the Egyptian-Israeli peace treaty, as part of the reconciliation, the US postponed the planned sale of fifty US-manufactured F-5E jet fighters to Cairo, a political reward to Egypt for signing the peace treaty with Israel (which would be paid for by Saudi Arabia in a deal which cost $525 million). [111] In mid-1979, Saudi Arabia tried to rally the small Gulf countries around itself, but some of them still doubted Saudi capacity to provide them with an adequate defense umbrella.[112] In this situation, Saudi Arabia wanted to repair its relations with the US to acquire military support from its old patron. A return to its traditional oil policy would satisfy all these needs.

Although the higher level of Saudi oil production – around 9.5 million b/d – was clearly designed to bring a sharp fall in spot market prices and consequently to reach a compromise reunification of the OPEC oil price, Saudi Arabia failed to check the increasing influence of market forces over oil prices at the end of 1979. Even after the decision to increase output to 9.5 million b/d in July 1979, the gap between OPEC's official prices and spot prices had widen until the fourth quarter of 1979. While the

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[109] Petroleum & Energy Intelligence Weekly, "Saudis Set Output Rise that Might Cover Oil Shortfall," *Petroleum Intelligence Weekly* XVIII, no. 28 (July 9, 1979): 3.

[110] Long, *The United States and Saudi Arabia*, 63.

[111] Posner, *Secrets of the Kingdom*, 90.

[112] Safran, *Saudi Arabia*, 404-05.

premium for Mideast Light Crude 34° on the spot market had risen from $14.01 in the third quarter to $15.33 in the fourth quarter, the premium for Mideast Heavy Crude 31° had risen from $10.84 in the third quarter to $11.18 in the fourth quarter. African Light Crude 37/40 had experienced the biggest premium increase on the spot market, from $12.34 in the third quarter to $14.19 in the fourth quarter.[113] According to *PIW's* analysis, fear and uncertainty over future oil supplies were the main motivations keeping the spot market prices for OPEC crudes in the range of $32 to $37 a barrel, in spite of the improved supply. Although OPEC members claimed that they would limit their transactions in the spot market, they showed little restraint.[114] As the differences between OPEC's official prices and spot prices became bigger, some OPEC countries tried to sell more of their oil on the spot market. For example, in a statement to the press in Vienna on October 4, 1979, Iran's Deputy Minister for Economic and International Affairs, Cyrus Ebrahimzadeh, disclosed that Iran was selling 12-15% of its oil output on the spot market at that time, asking $36.50/barrel for Iranian Light and $34.50 for Iranian Heavy against the official prices of $22.00/barrel and $19.90/barrel, respectively.[115] In September, even Dubai decided to sell part of its 360,000 b/d output on the spot market by offering 100,000 b/d to the Conoco group at roughly $33 a barrel and further increased its output

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[113] Petroleum & Energy Intelligence Weekly, "What's New: Here's PIW's 10-Year Overview," 11.

[114] "Future Supply Fears Hold Spot Crude Prices High for Now," *Petroleum Intelligence Weekly* XVIII, no. 40 (October 1, 1979): 1-2.

[115] Middle East Petroleum and Economic Publications, "Iran: Iran Selling 12-15% of Output on Spot Market," *Middle East Economic Survey* XXII, no. 51 (October 8, 1979): 4.

for the sales of the spot market to 180,000 b/d in October.[116]

In a situation where market forces were causing a price upheaval, OPEC members continuously increased official oil prices, thus distorting OPEC's price differentials. On October 7, 1979, Kuwait decided to apply an additional surcharge of $1.94 a barrel on all its crudes effective October 1, compelling OPEC's upper tier to cluster prices around a $22 base level instead of the deemed $20 marker price in the summer. Apart from lower-tier Saudi Arabia's $18 Arabian Light, OPEC's July 1 rise was virtually arranged at a $20 market base, in which OPEC's key crudes ranged between $19.50 and the $23.50 ceiling.[117] After Kuwait's decision in October, other OPEC members followed suit by increasing their official oil prices. In particular, Iran's move to increase its 34-gravity marker-type crude to $23.50 led Algeria, Libya, and Nigeria, which had better quality oil, to break the $23.50 ceiling.[118] In an attempt to achieve a unified OPEC price scale, Saudi Arabia increased its marker Arabian Light crude price by $6 to $24 a barrel, retroactive to November 1 with price increases from Abu Dhabi, Qatar and Venezuela, other moderate members of OPEC, before the Caracas

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116 Petroleum & Energy Intelligence Weekly, "Dubai Will Take Half of Oil Output for Spot Sales," *Petroleum Intelligence Weekly* XVIII, no. 44 (October 29, 1979): 3.

117 "Kuwait's Price Rise Reinforces Shift to Higher OPEC Base," *Petroleum Intelligence Weekly* XVIII, no. 42 (October 15, 1979): 1.

118 "Libya and Iran Stir Another OPEC Oil Pirce Upheaval," *Petroleum Intelligence Weekly* XVIII, no. 43 (October 22, 1979): 2-3; "New Price Increases Poke More Holes in OPEC Ceiling," *Petroleum Intelligence Weekly* XVIII, no. 44 (October 29, 1979): 1-2.

OPEC Conference.[119] Although OPEC members failed to set the benchmark price at the conference in Caracas, because the organization did not endorse Saudi Arabia's new $24 a barrel price for Arabian Light crude as the OPEC marker, volatile market conditions at that moment led even the group of four moderates, Saudi Arabia, Abu Dhabi, Qatar and Venezuela, to increase prices steeply and push the marker up to $24 a barrel.[120] Regarding the disappointing outcome of the Caracas Conference, the Petroleum Times noted on January 1, 1980: "It showed that OPEC countries now accept that they do not need the Organization to make crude oil prices stick. They can go it alone now. The market has taken over."[121] It was clear that market forces had considerably distorted OPEC official price differentials. The impasse at the Caracas Conference resulted in stretching OPEC's official pricing differentials more than five times wider than the $2 price spread in late 1978.[122]

To achieve the reunification of OPEC's oil prices, reducing the gap among the organization's official pricing differentials, Saudi Arabia was obliged to increase its marker price for Arabian Light crude. In early January 1980, only a few weeks after its decision to increase its Marker Crude price to $24 a barrel, the three key African producers – Libya, Algeria and Nigeria – increased their crude prices, claiming market

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[119] "OPEC 'Moderates' Raise Prices Hoping to Re-Establish Unity," *Petroleum Intelligence Weekly* XVIII, no. 51 (December 17, 1979): 1.

[120] "Moderates Gamble that Supply Surplus Will Reunify Prices," *Petroleum Intelligence Weekly* XVIII, no. 52 (December 24, 1979): 3-4.

[121] Benjamin Shwadran, *Middle East Oil Crisis since 1973* (Boulder and London: Westview Press, 1986), 156.

[122] Petroleum & Energy Intelligence Weekly, "World Oil Markets Don't Support OPEC Differentials," *Petroleum Intelligence Weekly* XIX, no. 2 (January 14, 1980): 1-2.

surcharges, compensation for retroactivity and exploration fees, ranging from $33 to $35 a barrel bracket for the first quarter of 1980.[123] Hence, Saudi Arabia seemed to have lost its price bargaining leverage in spite of its huge production of 9.5 million b/d in late 1979 and early 1980. For the restoration of its bargaining power vis-à-vis other OPEC members, it should have increased its official oil prices. Soon after it increased its official marker price from $18 to $24 a barrel in December 1979, it was in a position to increase its official price to $26 a barrel in late January 1980. The Saudis explained informally to their clients that the decision to make a $2 per barrel increase was designed to equalize their prices in line with the other moderates. However, this policy completely failed. It took only days for other Gulf producers – Kuwait, Abu Dhabi, Qatar and Iraq – to rally to a new $28 benchmark by raising their prices $2 a barrel.[124] In spite of sliding demand and the "mini-glut" in April 1980, there was a rise in spot prices for Middle East crudes because of the potential for a Middle East supply disruption arising from the situation in Iran.[125] On May 14, Saudi Arabia again increased its Marker Crude price to $28 per barrel, retroactive to April 1. Yamani clarified the reasons for the price rise of $2 per barrel, "firstly as a step towards the reunification of OPEC prices, and secondly to take

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[123] "Price Rises Escalate from One African Producer to Another," *Petroleum Intelligence Weekly* XIX, no. 1 (January 7, 1980): 3-4.

[124] "New Price Rises Merely Lift OPEC Split to Higher Level," *Petroleum Intelligence Weekly* XIX, no. 5 (February 4, 1980): 1-2.

[125] "Spot Crude Prices React to Renewed Supply Worries," *Petroleum Intelligence Weekly* XIX, no. 16 (April 21, 1980): 3; After the Iran hostage crisis in November 1979, President Carter urged his allies in April 1980 to join with the US in the imposition of diplomatic restraints and economic sanctions, while he opened the possibility of the military option to solve the Iran hostage crisis. See Middle East Petroleum and Economic Publications, "Iran: US Escalates Pressures on Allies to Join Sanctions against Iran," *Middle East Economic Survey* XXIII, no. 27 (April 21, 1980): 2-3.

back some of the profits currently being realized by the oil companies on Saudi oil and to narrow the gap between our Saudi price and the market price."[126] Soon after the $2 a barrel increase in May, most other OPEC members except Iran enacted further price rises, making the majority's *de facto* benchmark price from $28 to $30 per barrel. In the end, all Saudi Arabia's attempts to reunify the OPEC oil price in the first half of 1980 triggered a spasm of leapfrogging among OPEC members.[127] Shwadran describes this unique oil market situation, noting that "A pattern had become well established: After each Saudi price increase, the other producers raised their higher prices by a similar amount and retained the premiums."[128]

Given that world oil prices were still out of Saudi Arabia's control at the end of 1979 and the early 1980s in spite of its efforts to stabilize the world oil market by considerably increasing its output and raising its official oil prices to narrow the gap between OPEC's official differentials, the best strategy for the Saudis in their effort to reunify OPEC's oil prices was to ask the oil consuming countries to conserve their oil consumption rather than to make use of their own additional production capacity. Replying to a question on the level of oil production in the fourth quarter of 1979 in a statement to the Saudi Press Agency on September 26, Prince Fahd expressed the hope "that the major consuming countries will grasp this opportunity to take serious steps to

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[126] "Yamani Clarifies Reasons for $2/Barrel Price Rise," *Middle East Economic Survey* XXIII, no. 31 (May 19, 1980): 1-2.

[127] Petroleum & Energy Intelligence Weekly, "OPEC Leapfrogging Jumps Average Price to $32," *Petroleum Intelligence Weekly* XIX, no. 21 (May 26, 1980): 3.

[128] Shwadran, *Middle East Oil Crisis*, 157.

reduce consumption and to put an end to waste in using energy."[129] Furthermore, Saudi Arabia considered that its output of 9.5 million b/d was big enough for the supply requirements of the world oil market. On October 20, 1979, *The Economist* reported that Saudi Arabia was considering a further increase in its oil production by 1 million b/d to 10.5 million b/d. However, in Los Angeles on October 26, Yamani denied any plan to increase output beyond the current level of 9.5 million b/d, mentioning, "I don't think the question is one of increasing supply. The question is one of reducing consumption drastically so that you, the consumer, can correct the balance, stop this upward trend and reduce the price of oil."[130] With growing concerns over a looming energy crisis in the future, which would be initiated by supply disruptions, it seemed to be more rational for Saudi Arabia to ask the oil-consuming countries to conserve their oil consumption rather than to add extra additional output to the world oil market in order to reunify the OPEC price. In addition, it was widely anticipated that if Saudi Arabia increased its output to 10.5 million b/d, the decision would rouse other OPEC members' antipathy and would make it very difficult to achieve price unity. However, as Saudi Arabia appeared to be trying to exert a lot of pressure on the consuming countries to stabilize the world oil market rather than increasing its output by an extra 1 million b/d, it was evidently hoping for greater compromise over the reunification of OPEC's oil prices.

Saudi officials anticipated that a surplus would reemerge on the crude oil market in early 1980 with their continuing overproduction at the level of 9.5 million b/d and that

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[129] Middle East Petroleum and Economic Publications, "Saudi Arabia Maintains 9.5 Million B/D Output," *Middle East Economic Survey* XXII, no. 50 (October 1, 1979): 1-2.

[130] "Saudi Arabia: Yamani Denies Saudi Arabia Has Any Plan to Increase Output to 10.5 Million B/D," *Middle East Economic Survey* XXIII, no. 3 (November 5, 1979): 1.

this development would help OPEC achieve a reunification of its price.[131] In an interview with *al-Sharq al-Awsat* on May 29, Yamani mentioned that “predictions by Saudi officials last year of a surplus in 1980 had proved accurate, despite a drop in Iranian production from 3.5 million b/d to well below 2 million b/d, and that if Iranian output had remained at the higher level the surplus would have already posed a threat to countries charging high prices.”[132] He even put pressure on other OPEC members to reunify oil prices, warning “we expect that the oil surplus will increase further – either this fall or next spring – leading to a major collapse in oil prices and major disruptions within certain OPEC member countries.”[133] Because of the burgeoning crude oil supply surplus, Nigeria was obliged to cut its production by nearly 10% at the end of July.[134]

The continuing rises in Saudi Arabia’s official oil prices and its high oil production of 9.5 million b/d certainly contributed to the stabilization of spot prices during the summer of 1980. The rising official prices of OPEC crude were close to open-market spot prices for some Middle East and African crudes in early June, making premiums on those crudes nearly zero.[135] When the OPEC Conference was held in Algiers on June 9-11, the situation of the world oil market bore out Yamani’s confident

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[131] "Saudi Arabia Looks to Compromise Reunification of OPEC Prices When Oil Surplus Reemerges," *Middle East Economic Survey* XXII, no. 52 (October 14, 1979): 4.

[132] "Saudi Arabia: Yamani Forecasts Collapse of Oil Prices if Reunification Fails," *Middle East Economic Survey* XXIII, no. 33 (June 2, 1980): 5.

[133] Ibid.

[134] Petroleum & Energy Intelligence Weekly, "Oil Surplus Forces Nigeria to Slash Its Output by 10%," *Petroleum Intelligence Weekly* XIX, no. 31 (August 4, 1980): 1.

[135] "Spot and Official Crude Oil Prices Coming Together," *Petroleum Intelligence Weekly* XIX, no. 22 (June 2, 1980): 1-2.

December prediction that there would be a glut and a definite drop in the spot market. There was little room for Mideast and African price hawks to drive their oil prices, respectively, to more than \$2 to \$5 and a \$1 to \$1.50 a barrel increase.[136] At the Conference in Algiers, OPEC decided to set the price level for a Marker Crude (i.e., a theoretical Marker Crude, not the actual 34° API Arabian Light) to a ceiling of \$32 a barrel and to limit the value differential to be added over the marker price ceiling to a maximum of \$5/b, setting an overall price ceiling for all OPEC crudes of \$37/B, effective from July 1. According to Seymour, the decisions in Algiers recalled the short-lived ceiling price agreement in Geneva a year before. However, there was a fundamental difference between these two events. While the world oil market was tight in the middle of 1979, it was easing and softer in June 1980. In Seymour's words, "whereas the June 1979 OPEC price arrangement can be seen to have been a step on the road towards price diversity, the Algiers compromise may turn out to be a positive move towards reunification."[137] At the end of June, some OPEC crudes, particularly the higher priced African crudes, were selling on the spot market below the scheduled July official OPEC levels for the first time since 1978. In early August, some of African spot crudes were even selling as much as \$4 a barrel below the official OPEC levels.[138] However, spot prices of \$33 a barrel for Arabian Light-type of Mideast crudes were still above most of

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[136] "Spot Oil Prices Argue against Big OPEC Price Boost," *Petroleum Intelligence Weekly* XIX, no. 23 (June 9, 1980): 3.

[137] Ian Seymour, "OPEC: A Tentative Step towards Price Unification," *Middle East Economic Survey* XXIII, no. 35 (June 16, 1980): 1-2.

[138] Petroleum & Energy Intelligence Weekly, "Spot Crude Markets Start Falling below Official Prices," *Petroleum Intelligence Weekly* XIX, no. 26 (June 30, 1980): 1, 9; "African Spot Prices Drop \$4 below Official OPEC Levels," *Petroleum Intelligence Weekly* XIX, no. 31 (August 4, 1980): 1.

their official levels in early August, despite a $1 a barrel slide in those spot prices.[139] In August, spot crude oil prices were spiraling downward the $32 OPEC floor that the OPEC majority had set for Mideast crude.[140]

Saudi Arabia kept on trying to reunify the OPEC price system, but these efforts, which seemed promising, were interrupted by the outbreak of the Iran-Iraq War on September 22, 1980. With the progressive softening of the oil market, Saudi Arabia's bargaining power improved considerably. At the OPEC Conference in Vienna on September 17-18, it offered to make a voluntary production cut of 1 million b/d back to its traditional 8.5 million b/d under the condition that OPEC would agree to reunify the OPEC marker price to around $30/b, as well as coming to an agreement on realistic price differentials between the marker and other OPEC crudes. This should have brought down their prices in turn. However, this failed to gain full agreement from the other OPEC members and the Saudis decided to maintain production at 9.5 million b/d for the time being.

In Vienna, OPEC decided to fix the official price of Marker Crude at $30/b, less than the ceiling of $32/b for the Marker Crude decided on at the last Algiers Conference and $2 more than the current Arabian Light price of $28/b. Yamani, the chairman and main sponsor of OPEC's Long-Term Strategy group, must have been satisfied with the Vienna compromise that the long-term pricing formula would operate on January 1, 1981 after the expected endorsement by the Summit and would require an automatic increase

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[139] "Mideast Spot Prices for Crude Slip but Hold above Official," *Petroleum Intelligence Weekly* XIX, no. 31 (August 4, 1980): 3.

[140] "Spot Crude Prices Tumble toward $32 OPEC Floor," *Petroleum Intelligence Weekly* XIX, no. 32 (August 11, 1980): 1.

in the price of Marker Crude towards the upper tier level. This means that the prices of the other OPEC crudes would remain at their September level until the formula-escalated price of Saudi Marker Crude caught up, and from then on all OPEC crude prices would rise together within OPEC's price frame based on agreed realistic differentials.[141] As *PIW* mentioned, "The OPEC decision is widely considered to be the first step toward a later full and complete unity move."[142] Under the softening oil market condition, OPEC's price reunification seemed to be just around the corner. However, the outbreak of the Iran-Iraq War ruined all Saudi Arabia's efforts to reunify OPEC prices based on the Long-Term Strategy.

Soon after the outbreak of the Iran-Iraq War, the world oil market became volatile again with exploding spot market prices for OPEC crudes and Saudi Arabia immediately increased its oil production by almost 900,000 million b/d from 9.5 million b/d to 10.4 million b/d on October 2 to compensate for the loss of world supply from Iran and Iraq. In early October, Arabian Light-type crudes were traded on the spot market with a $5 to $6 premium over the OPEC marker base agreed to in Vienna, ranging from $35 to $36 a barrel, while spot prices for some top quality OPEC African crudes moved up to the official level of $37 a barrel. The Saudis increased their output to an almost maximum level of 10.4 million b/d to prevent panic buying by consumers, as well as another price hike. As another price runaway would severely undermine Saudi hopes of fostering a predictable long-term OPEC pricing system based on unified prices, the Saudi

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[141] Ian Seymour, "OPEC Sets Base Marker Crude Price at $30/Barrel," *Middle East Economic Survey* XXIII, no. 49 (September 22, 1980): 1-2.

[142] Petroleum & Energy Intelligence Weekly, "OPEC Accord Doesn't Resolve Oil Pirce Disparities," *Petroleum Intelligence Weekly* XIX (September 22, 1980): 4.

government supplied an additional 900,000 b/d to the consumer countries to maintain the stability of the world oil market.[143]

Apart from the Saudi boost, three other Arab producing states also planned to boost their production for the fourth quarter to help compensate for the war shortfall, respectively, 350,000 to 400,000 b/d from Kuwait, 50,000 to 100,000 b/d from Abu Dhabi and 20,000 b/d from Qatar. One of main reasons why these Gulf countries joined Saudi Arabia's production boost was to give Iraq financial support for the war against Iran. It was said that revenues from the incremental output of these Gulf states would be recycled to Baghdad as soft loans at various times and that they would honor the contracts of Iraq's oil customers.[144] In reality, Saudi Arabia loaned Iraq at least $10 billion in 1981 alone and Kuwait provided Iraq with three tranches of interest-free loans of $2 billion in 1980, April and December 1981. The UAE also loaned between $1 billion and $3 billion in 1981, and Qatar added a further $1 billion.[145] In spite of the practical difficulties of transferring Iraq's customers to other Arab Gulf states and renegotiating new contracts, the make-up allotments carried out by these states helped cover the

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[143] "Saudi Supply Hike of 9.5% May Curb Price Surge," *Petroleum Intelligence Weekly* XIX, no. 40 (October 6, 1980): 1; "Iran-Iraq Cutoff Fires up Spot Crude Oil Markets," *Petroleum Intelligence Weekly* XIX, no. 40 (October 6, 1980): 2.

[144] "Mideast Producers Start Dividing up Extra Crude Supply," *Petroleum Intelligence Weekly* XIX, no. 43 (October 27, 1980): 3-4.

[145] Iran threatened all the Arab Gulf states that favored and cooperated with Baghdad, and made air strikes against Kuwait as early as November 12 and 16, 1980 as a warning to those countries. See Rob Johnson, *The Iran-Iraq War: Twentieth Century Wars* (Basingstoke and New York: Palgrave Macmillan 2011), 94.

shortages caused by the war.[146] The political exigencies of the Iran-Iraq War not only contributed to the orchestration of oil policies among Arab Gulf states in late 1980, but also helped to encourage the establishment of the Gulf Cooperation Council (GCC) in May 1981.

Rather than any real scarcity of supplies, the psychological reactions of consumers pushed up spot crude prices at the end of 1980. During this period, most specialists were expecting a near-balance between supply and demand for 1981 as a whole. While world oil demand was falling rapidly enough to check another possible price run-up in 1981, the production of non-OPEC producers was constantly increasing. High inventories were also expected to help the stabilization of the world oil market with a relatively modest but carefully orchestrated drawdown of inventories.[147] In addition, Saudi Arabia was actively committing itself to market stability by increasing its oil production to almost maximum levels with the extra production boost from the Gulf states. However, as *PIW* analyzed, the absence of oil from Iran and Iraq could not restrain spot crude oil prices. Growing fears about the future of the oil market not only encouraged speculative traders to dominate the spot crude market, but also led end-users to be willing to pay extra spot premiums on OPEC crudes.[148] The world oil market could not be relieved from supply worries in late 1980. Arabian Light crude reached

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[146] Petroleum & Energy Intelligence Weekly, "Oil Supply Allotment Posing Dilemma for Gulf States," *Petroleum Intelligence Weekly* XIX, no. 47 (November 24, 1980): 2-3.

[147] "Falling Oil Demand Plus Stocks Could Stunt Price Spiral," *Petroleum Intelligence Weekly* XIX, no. 46 (November 17, 1980): 3.

[148] "Traders Not Alone in Pushing up Spot Crude Prices," *Petroleum Intelligence Weekly* XIX no. 44 (November 3, 1980): 1.

unprecedented levels of $41.75 to $42 or more a barrel on the spot market and top quality African oils were $43 a barrel or higher in November 1980.[149] The world oil market, which had been close to a reunification of OPEC's oil prices in the middle of 1980, became volatile again, and Saudi Arabia had to wait until 1981 for price unification within OPEC.

While the global oil market was still exposed to the uncertainty of the Iran-Iraq War and there were fears of scarcity among consumers at the end of 1980, Saudi Arabia put intense pressure on the oil-consuming countries to cooperate with its efforts to achieve market stability. In an interview with AP-Dow Jones on November 10, 1980, Yamani urged the oil consuming countries and the oil companies to avoid panic buying on the spot market and to draw down their ample stocks to prevent a new price explosion. He warned that his country would not increase production any further if panic buying set in and the companies refused to destock.[150] As we will see in Chapter VIII, in response to Yamani's request, the IEA countries decided to draw down their inventories in an effort to reduce oil imports. In an interview with the Saudi-owned, London-based daily *al-Sharq al-Awsat* on December 4, 1980, Yamani showed his satisfaction with the IEA countries' response to his request for destocking, saying: "I think they are reducing their stocks in the manner required…..I am not as concerned as I was three weeks ago."[151]

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[149] "Spot Crude Prices May Be Peaking at $42 Record High," XIX, no. 47 (November 24, 1980): 1.

[150] Middle East Petroleum and Economic Publications, "Saudi Arabia: Yamani Warns of New Prices Rise if Spot Purchases Continue Unabated," *Middle East Economic Survey* XXIV, no. 5 (November 17, 1980): 5-6.

[151] "Yamani Sceptical about Oil Price Agreement at Bali," *Middle East Economic Survey* XXIV, no. 9 (December 15, 1980): ii.

During the early part of the Iran-Iraq War, when the world oil market was experiencing a fair degree of turmoil, Saudi Arabia did its best to stabilize it, but in ways which would enable it to return to the pursuit of its long-term economic interests. If Saudi Arabia wanted to use the Iran-Iraq War as an opportunity to increase oil prices and decided to pursue short-term financial profits as much as possible regardless of its long-term economic interests – and some commentators were describing it as a greedy profit-seeking country during this period – there was no reason why Saudi leaders should have decided to increase oil production to almost maximum levels and urged oil consumers to destock their high inventories and to avoid panic buying on the spot market.

On the other hand, Saudi Arabia was obliged to agree to increase its Marker Crude price as an attempt to stabilize the world oil market for the reunification of OPEC's prices. At the Bali Conference on December 15, 1980, OPEC surprisingly reached an agreement that set Saudi marker at $32/b and allowed Saudi Marker Crude to range between $32/b and $36/b with a maximum differential of $5/b for premium crudes to make for an overall ceiling of $41/b for all OPEC crudes. *MEES* news editor Seymour describe the compromise outcome of the Bali Conference with some surprise: "It was not expected that any agreement could be reached on a substantive issue like prices on which, apart from the political tensions, the divergences of view were thought to be too wide to be bridged by any feasible accommodation."[152] Saudi Arabia's efforts to stabilize the world oil market began to work in December, and there were little incentives for other OPEC members to insist on huge price increases. Spot prices hit a record $42 to $44 a barrel in the third week of November and then began to slide some $2 to $3 at the end of

[152] Ian Seymour, "OPEC Agrees on $32-$36/B Marker Price Spread," ibid., no. 10 (December 22, 1980): 1.

November. With the limited resumption of exports from Iraq and Iran at the end of 1980, many buyers took a "wait-and-see" attitude, expecting further spot price drops.[153] Before the Bali Conference, *PIW* had already anticipated that the fall-off in spot crude and products prices due to the extremely small volumes of crude spot transactions might lead OPEC members to agree on some moderate increases.[154] With market conditions favoring such moderate increases, Saudi Arabia could move toward the reunification of OPEC's oil prices by reaching an agreement with other OPEC members, although their crude prices still needed to be readjusted.

With these gloomy prospects for the future of the oil market, OPEC members tried to increase their prices as much as possible. In early January, after Libya's striking move to raise its official crude prices by $4 a barrel to the $41 a barrel maximum, the price for all crudes set at the Bali meeting, the Gulf oil producers, instigated by Qatar and Kuwait, decided to raise their official prices by $4 a barrel effective as of January 1. These retrogressive developments made the oil consuming countries' expectations of some price moderation on the part of non-Saudi producers in the Middle East seem just an illusion. According to *PIW*, none of these decisions resulted from these countries' strategic consideration to increase their official oil prices by making use of the tight market situation caused by the Iran-Iraq War, but were rather the reflection of their fear

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[153] Petroleum & Energy Intelligence Weekly, "Spot Crude Prices Slipping from Record as Market Slows," *Petroleum Intelligence Weekly* XIX, no. 48 (December 1, 1980): 1-2.

[154] "Price Restraint Seen Likely at OPEC Bali Meeting," *Petroleum Intelligence Weekly* XIX, no. 50 (December 15, 1980): 1-2.

of future market weakness.[155] After all, the Gulf oil producers' decisions to raise their official prices by $4 a barrel reached OPEC's deemed $36 marker level. However, their attempts to keep their official oil prices at high levels could not survive for long.

In spite of the continuation of the Iran-Iraq War, the market situation in 1981 did not become more favorable for the oil producing countries. Mainly because of the structural changes in the oil market and Saudi Arabia's efforts to achieve stability, the effects of the war were not big enough to lead to another price spiral in 1981. As we will see in Chapter VIII, falling oil demand and destocking from oil-consuming countries brought about a fundamental shift in the world oil supply/demand balance in 1981. In particular, the decline in oil demand in IEA member countries was already noticeable in 1980, when their aggregate net oil imports fell more than 15% below the 1980 target ceiling they had adopted in December 1979. Oil consumption among IEA members fell continuously and rapidly in 1981.[156] The drawing down of inventories on the part of a large number of oil companies also accelerated the fall in OPEC's spot prices in April 1980.[157] Furthermore, Yamani vowed publicly in mid-April that Saudi Arabia would neither raise its lower oil prices nor reduce its abnormally high production of around 10.25 million b/d, which accounted for 41% of OPEC's reduced production, simply to

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[155] Middle East Petroleum and Economic Publications, "Libya Moves to $41/B OPEC Price Ceiling," *Middle East Economic Survey* XXIV, no. 12 (Januray 5, 1981): 1; Petroleum & Energy Intelligence Weekly, "Hope of Moderation in Mideast Prices Fades with $4 Rise," *Petroleum Intelligence Weekly* XX, no. 2 (January 12, 1981): 1-2; "Fear of Soft Market Seems behind Latest Mideast Price Rise," *Petroleum Intelligence Weekly* XX, no. 3 (January 19, 1981): 1-2.

[156] "Rapid Demand Drop Leaves IEA Import Target Far Too High," *Petroleum Intelligence Weekly* XX, no. 23 (June 8, 1981): 7-8.

[157] "Stock Liquidation Driving Spot Crude below Marker Price," *Petroleum Intelligence Weekly* XX, no. 16 (April 20, 1981): 1.

restore OPEC's unified crude oil pricing. He even declared aggressively, "We engineered the glut and we want to see it in order to stabilize the price." He warned repeatedly that "price unification would require some other producers to come down in their prices and not to expect any lowering of Saudi production for the time being, until we unify."[158] In fact, in spite of the efforts of Iran and Iraq to increase their crude oil exports in the second quarter of 1981, gluts on the world oil market became a greater obstacle than the continuation of the war.[159]

In this slack market situation, oil prices on the spot market became more stable during 1981, leaving little room for OPEC radicals to increase official prices. With the renewed export supply from Iraq and Iran in a weak market, the premiums on African crudes were eliminated in February 1981, as buyers began to refuse to pay premium prices for long-term contracts with African producers.[160] Furthermore, the continuing slide of spot crude prices in early 1981 encouraged some oil company suppliers to sell their African crudes on a contract basis over the next nine to twelve months at "guaranteed" prices near official levels.[161] In the middle of April 1981, spot prices for Mideast crudes began to sink below OPEC's deemed $36 marker level, while spot prices

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[158] "Yamani Talks Tough on Saudi Pricing and Output Goals," *Petroleum Intelligence Weekly* XX, no. 17 (April 27, 1981): 5.

[159] "Iraq, Iran Oil Sales Stymied More by Glut than War," *Petroleum Intelligence Weekly* XX, no. 23 (June 8, 1981): 1.

[160] "OPEC Premiums on Contract Deals Face Stiff Resistance," *Petroleum Intelligence Weekly* XX, no. 8 (February 23, 1981): 3.

[161] "Crude Sellers Offer One-Year Deals as Prices Slide," *Petroleum Intelligence Weekly* XX, no. 12 (March 23, 1981): 2.

of African-type crudes fell to $3 to $4 a barrel below official levels.[162] In early May, spot prices for Mideast crudes were heading down toward $33, only $1 above Saudi Arabia's official Marker Crude price of $32 a barrel. Even prices for some North Sea crudes plunged faster than the $1 a barrel weekly rate of spot price declines for Mideast oil.[163] In early June, the spot market selling price for Arabian Light crude fell to the official level of $32 a barrel, mainly because of Saudi Arabia's pricing and supply policy. According to *PIW*'s pricing data, the premium for Arabia Light crude on the spot market was eliminated for the first time since mid-1978. More strikingly, spot market discounts on expensive North Sea and African crudes recorded above $6 a barrel at that time.[164] In late June, spot crude oil prices for Arabian Light crude finally fell below the psychological floor of $32 a barrel.[165] There were some fluctuations in spot oil prices during the second half of 1981, sending mixed and confusing signals to OPEC members trying to analyze the oil market. However, they could not avoid falls in their prices on the spot market in general, which severely undermined their official prices.[166]

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[162] "Stock Liquidation," 1, 6-7.

[163] "Another Spot Price Milestone Reached for Saudi Crude," *Petroleum Intelligence Weekly* XX, no. 19 (May 11, 1981): 3.

[164] "Saudis Succeed in Driving Spot Crude Prices to $32," XX, no. 23 (June 8, 1981): 3.

[165] "Spot Crude Prices Now Slipping below $32 Saudi Floor," *Petroleum Intelligence Weekly* XX, no. 25 (June 22, 1981): 1.

[166] "Spot Crude Prices Revive as Buyer Exodus Cuts Supply " *Petroleum Intelligence Weekly* XX, no. 28 (July 13, 1981): 3-4; "Market Seesawing as Spot Crude Prices Slump Again," *Petroleum Intelligence Weekly* XX, no. 31 (August 3, 1981): 4; "Spot Crude Prices are Weakening Again on All Fronts," *Petroleum Intelligence Weekly* XX, no. 36 (September 7, 1981): 1-2; "Spot Crude Markets Rise in Line with $34 Base for Now," *Petroleum Intelligence Weekly* XX, no. 45 (November 9, 1981): 5; "Spot

Saudi Arabia regarded $34 a barrel as an acceptable price on which it could compromise with other OPEC members for the reunification of OPEC's pricing system. According to Seymour's analysis, the Saudis strongly believed that the high oil prices of Mideast crudes (around $36 a barrel) pursued by other OPEC members were a big mistake, because this overpriced oil could be challenged by immediate market realities and would guide consumer reactions in the longer-term toward conservation or/and substitution of alternative energy sources. In their perspective, this mistake could be partially corrected, as other Mideast crudes cut their prices by $2 a barrel to meet Saudi Arabia half-way at $34 a barrel.[167] At the Geneva Conference on May 25-26, 1981, Saudi Arabia failed to achieve reunification at $34/b and OPEC decided "to maintain the deemed Marker Crude price at a ceiling of US$36/b with a maximum OPEC price of US$41/b until the end of the year."[168] In spite of the freeze on the price ceilings on marker and premium crudes until the end of 1981, Saudi Arabia strongly refused to raise its official marker price or decrease production, because it was firmly determined that this quid prod quo would be only provided in return for reunification at $34/b.[169] Although the Saudis insisted that the final communiqué should omit any reference to the official crude marker price at the $32 level, seemingly opening the possibility of a change in Saudi oil policy in the near future, their attitude toward oil prices was adamant. At the

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Crude Market Starting to Undercut Official Prices," *Petroleum Intelligence Weekly* XX, no. 49 (December 7, 1981): 3-4.

[167] Ian Seymour, "Uneasy Status Quo Persists on OPEC Price Front," *Middle East Economic Survey* XXIV, no. 33 (June 1, 1981): 2-3.

[168] OPEC, *Official Resolutions and Press Releases*, 194.

[169] Seymour, "Uneasy Status Quo," 1.

Consultative Meeting in Geneva on August 19-21, the Saudi government refused a compromise proposal of $35 a barrel from several key members and took a strong position on OPEC's unified oil price, giving secret orders to its Aramco operating group to boost production temporarily to 10.2 million b/d as an effective way of limiting OPEC's base price to $34 a barrel.[170]

Saudi Arabia was finally able to achieve the reunification of crude oil prices at the Geneva Conference on October 29. OPEC members were in a position to reunify their official prices around a $34 a barrel marker price at the end of 1981. As Parra commented on the market situation in 1981, "By 1981, OPEC was trapped: non-OPEC sources of oil and new supplies of other energy, especially nuclear and coal, were coming in fast, at the same time, conservation measures and economic recession were reducing world demand for energy. Practically the whole increase in competing oil and energy supplies, as well as the reduction in overall demand, was coming out of OPEC's hide."[171] In a slack market situation, the major outcome for OPEC members at the Geneva meeting was a realignment of official crude prices around a marker of $34 a barrel. With the successful achievement of price unification in Geneva, Saudi Arabia decided to cut its output back to a ceiling of 8.5 million b/d. At that time, even the erstwhile price hawk, Iran, could have acknowledged the market reality. As Seymour pointed out, "Complementing the price aspect of the Geneva OPEC package—reunification of the marker price at $34.00/B, freeze till the end of 1982, and an agreed pattern of differentials—was Saudi Arabia's

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[170] Petroleum & Energy Intelligence Weekly, "Basis Now Set for Possible Move to Unified OPEC Price," *Petroleum Intelligence Weekly* XX, no. 22 (June 1, 1981): 5; "Price Gap of $1 Torpedoes OPEC's Bid for Unification," *Petroleum Intelligence Weekly* XX, no. 34 (August 24, 1981): 3.

[171] Parra, *Oil Politics*, 276.

own individual contribution to the deal."[172] Since 1979, Saudi Arabia had lost its power to control oil prices through OPEC and had made persistent efforts to reunify OPEC's oil pricing system in order to secure its own long-term economic interests. In the end, it achieved price unification in OPEC in October 1981. However, it faced new challenges in controlling oil prices over the next few years, mainly because of structural changes in the world oil market.

During the oil boom that had been in existence continuously since December 1976, the Saudis always tried to play as a swing producer (or a dominant firm in economic terminology) in the world oil market through OPEC. They must have believed that they could maximize the economic value of their oil wealth in the long-term by taking a swing producer role. To be a swing producer in the oil market, Saudi Arabia should have controlled oil prices as a price setter mainly within OPEC. In this respect, Yamani began to commit himself to the establishment of a long-term strategy for prices within OPEC, once he came close to achieving price unification in OPEC in late 1977. Until the early 1980s, Saudi officials had asked the oil-consuming countries to reduce their oil consumption and to encourage the development of alternative energy sources. Their behavior seemed to be far from the logic of Saudi Arabia's long-term economic strategy based on the dominant producer model. However, with skyrocketing oil prices on the spot market and widespread pessimism about the prospects for the future oil market at that time, this behavior could be understood as an attempt not only to stabilize the world oil market, but also to prevent shortages in the near future, which would severely undermine Saudi Arabia's long-term economic interests by challenging its

[172] Ian Seymour, "OPEC: Price Reunification at Last," *Middle East Economic Survey* Supplement to XXV, no. 3 (November 2, 1981): 1, 4.

position as a price setter. An evidently politically motivated oil policy in the first half of 1979 deepened their concern.

In the course of 1979, market forces began to increase their influence on oil prices and Saudi Arabia could not control them, even within OPEC. To restore its position as a price setter in the global oil market Saudi Arabia needed to reunify the OPEC pricing system. Without understanding the essence of Saudi oil policy and its political context during the oil boom, it seems at first sight both inconsistent and farfetched. In this period, with some exceptions, it was mainly based on Saudi Arabia's long-term economic interests. Hence the behavior of Saudi policy-makers could be understood as an attempt to secure Saudi Arabia's position as a price setter in the world oil market through OPEC.

CHAPTER VIII

STRUCTURAL CHANGES IN THE WORLD OIL MARKET

During most of the 1970s, the world oil market was under the control of OPEC and this very powerful organization was generally able to determine oil prices at will. OPEC exerted its largely unfettered power to control world oil prices during this period, and member countries enjoyed huge windfall revenues as a result of these high prices. The oil crisis in 1973-74 accelerated the end of the first oil price regime, which had allowed the major companies to maintain prices at a relatively low level without major fluctuations, and wielding power over oil prices now became concentrated in the hands of OPEC. The oil-consuming countries were not ready to defend their own economic interests vis-à-vis those of OPEC countries: in circumstances when the oil market became tight, oil-consuming countries were worried about disruptions in supply, while OPEC members were more concerned about the rapid depletion of their resources. The continuously increasing rise in demand in this period without any significant expansion of production capacity within OPEC made the oil-consuming countries increasingly vulnerable to blackmail or threats. During this period, the stability of the oil market seemed to be at the mercy of OPEC, particularly dovish Saudi Arabia.

OPEC members took it for granted that the oil-consuming countries should pay high prices during the boom period and they acted as if this tight market situation would continue for a long time and their predominant control over the world oil market would be perpetuated. In 1979, many western oil specialists and organizations had similar views on the future oil market. C.C. Pocock, the chairman of Shell Transport & Trading, predicted possible disruptions in oil supply in the 1980s and 1990s unless OPEC's production capacity were to reach the somewhat unrealistic figure of 45-50 million b/d in the near future.[1] The US Central Intelligence Agency (CIA) also had gloomy visions of supply shortages for the early 1980s if some OPEC governments were to adhere to conservationist policies that would result in OPEC producing 30 million b/d in the first half of the 1980s.[2] The International Energy Agency (IEA) provided equally pessimistic estimates of possible shortfalls of 1 million b/d in 1985, rising to over 6 million b/d by 1990.[3] In addition to these pessimistic opinions on future oil supplies, the experience of OPEC members in 1979-80 strengthened the illusion that this euphoric state of the world oil market had become chronic. The psychological aspect was a significant determinant of the oil market situation: as one oil supplier argued, "oil markets are 75% perception and 25% reality."[4] By the early 1980s, the high possibility of disruptions in oil supply and the conservationist attitude of OPEC members exacerbated oil consumers' panic over

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[1] Petroleum & Energy Intelligence Weekly, "Price is Sole Key to Supply-Demand Balance, Shell Says," *Petroleum Intelligence Weekly* XVIII, no. 26 (June 25, 1979): 5.

[2] "OPEC Oil Capacity, Production and Policies: Supplement," *Petroleum Intelligence Weekly* XVIII, no. 36 (September 3, 1979): 1-7.

[3] "IEA Sees Possible Oil Supply Shortage Looming next Year," *Petroleum Intelligence Weekly* XVIII, no. 49 (December 3, 1979): 2.

[4] "OPEC Output Cut Seen No Quick Fix for Soft Markets," *Petroleum Intelligence Weekly* XXI, no. 13 (March 29, 1982): 3.

oil supplies, which led them to rush to buy oil at whatever cost. At that point, the main concern of consumers was not price but how to secure the supply of this strategically important natural resource.[5] Until the early 1980s it seemed as if high oil prices had become an invariable norm on the world market. Such confidence in the future of the oil market was enough for OPEC members to direct their attention to a rearrangement of the world economy, which would reflect their increased economic power. During the celebrations of the 20th anniversary of OPEC in September 1980, members tried to urge the world to create a new economic order based on justice and fairness, emphasizing their increasing role in supporting the Third World.[6]

Although inauspicious tendencies were perceptible after the late 1970s, only a very few people expected structural changes in the world oil market and the resulting decline in OPEC's power to take place in the very near future. During the second half of the 1970s, non-OPEC production increased continuously, exceeding OPEC's production in 1978, reaching 52% of the world market share. Even at the height of OPEC's influence over the market in 1979, 1980 and 1981, non-OPEC output accounted for 52.1%, 56.1% and 60.4%, respectively, of world oil production, while OPEC's market share decreased correspondingly (see Table 4). After the 1973-74 oil embargo, the oil-consuming countries began to stockpile as a form of defense against possible disruptions in supply or skyrocketing oil prices. Through the mechanism of stockpiling and destocking in accordance with the market situation, they effectively increased their bargaining power vis-à-vis OPEC members. Furthermore, market forces began to have an increasing

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[5] Shwadran, *Middle East Oil Crisis*, 160.

[6] OPEC, *Official Resolutions and Press Releases*, 184-89.

influence on the oil market at the end of the 1970s and signs of a drop in demand for oil were already noticeable by 1980 (See Table 2). In the early 1980s, however, most members of OPEC still believed that there was no alternative for oil-consuming countries to pay the high oil prices that they were imposing. They added premiums and surcharges on their crude oil without any considerations of economic logic during the late 1970s and early 1980s. At the meetings of OPEC during this period, OPEC members' voices were so victorious and boastful that no one expected that the gradually changing environment of the world oil market would affect the whole price structure of OPEC and challenge its predominant position.

The Decrease in Demand for Oil

The high oil prices imposed by OPEC in the 1970s finally led to a reduction in the demand for oil in the first half of the 1980s, and oil consumption did not fully recover even after the oil price collapse of 1986. The trend of continuously increasing oil demand in the history of oil entered upon a new phase in the 1980s. According to a Texaco analysis made available to *PIW* by chief economist Dr. Tor Meloe in 1983, consumer reaction to OPEC's high oil prices during the 1970s erased more than 13 million b/d of potential world oil demand and the impact of high oil prices on oil demand would be reflected for a long time. Furthermore, the "lost growth opportunities" for oil are much greater than the high price-induced 4.5 million b/d decline in Free World oil demand since 1979. In his view, high oil prices in the 1970s encouraged oil conservation and substitution, particularly in the US and Europe, running, respectively, 5.1 million b/d and

5.8 million b/d in oil demand less than their potential in 1982.[7] In spite of the recovery of the world economy after 1982 and the oil price collapse of 1986, oil demand did not get back to 1979 levels until 1988 (See Table 2).

Early in 1980, when OPEC members enjoyed high oil prices and their dominant power in the world oil market, the sign of softening demand could be witnessed. According to *PIW*'s analysis, the sharp drop of 1.2 million b/d in OPEC's January 1980 production was largely due to softening demand, because there was no offsetting rise in non-OPEC output and only some 21% or 250,000 b/d of OPEC's January drop was directly related to planned production cuts.[8] Regardless of the conservationist tendencies of some OPEC members, they were obliged to cut their oil production in early 1980 due mainly to the decrease in demand, which would gradually challenge the predominant market power of OPEC.

More specifically, the drop in fuel oil consumption since 1972 was the most striking feature of oil demand in the 1980s. Fuel oil consumption in 1982 recorded a decrease of more than 20% over 1972. The drop in fuel oil consumption was more drastic in the major regional markets, plunging 37% in Japan, 36% in Western Europe and 33% in the United States.[9] Fuel switching initiated by the high prices of the 1970s was the main reason for the drop in fuel oil consumption. While Europe, Japan, and Canada increased their use of natural gas to offset the plunge in oil consumption, the US favored

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[7] Petroleum & Energy Intelligence Weekly, "Demand Lost by 1970s Oil Shocks Tops 13-Million B/D," *Petroleum Intelligence Weekly* XXII, no. 26 (June 27, 1983): 1.

[8] "Softening Demand Causing OPEC Oil Output to Drop," *Petroleum Intelligence Weekly* XIX, no. 10 (March 10, 1980): 1.

[9] "10-Year Trend Shows Major Structural Shift in Demand," *Petroleum Intelligence Weekly* XXII, no. 25 (June 20, 1983): 8.

coal, and all these countries increased their use of nuclear power.[10] Furthermore, the introduction of mixtures of pulverized coal with fuel oil in conventional oil-fired boilers also helped to reduce fuel oil consumption.[11]

The second oil crisis accelerated a major reduction in oil consumption. The impact of high oil prices on final consumers in 1978-1980 was much higher than before in 1972-1975, bringing a fast drop in oil demand in the OECD countries. OECD calculated that each 10% rise in the real price of the OECD's oil imports added about 1% to the inflation rate and reduced its overall GNP growth by 0.5% during the second oil crisis. While a 10% rise in the import oil price raised energy prices to final users 4.75% in 1978-1980, they had only experienced 2% increases in 1972-1975.[12] According to a comparative analysis by a large international bank, oil consumption in industrial countries dropped 45% more in 1979-81 than during the first oil price shock of 1973-75, mainly because a drop in oil consumption during the second oil crisis was closely related with price-induced conservation rather economic recession.[13] In a survey of energy economists in 1983, *PIW* found that approximately 50% to 75% of the 6 million b/d drop in oil demand since 1979 was due to conservation-related measures, and that in consequence economic recovery would not cause the demand for oil to bounce back very

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[10] "What's New around the World: Shift from Oil Favors Coal in U.S., Gas Elsewhere," *Petroleum Intelligence Weekly* XX, no. 48 (November 30, 1981): 8.

[11] "New Coal-Oil Mixes Could Crimp World Oil Demand," *Petroleum Intelligence Weekly* XX, no. 37 (September 14, 1981): 5.

[12] "OECD Demand Falls as Oil Price Hikes Hit Consumers Faster," *Petroleum Intelligence Weekly* XX, no. 2 (January 12, 1981): 7.

[13] "Conservation Seen Driving Force behind Falling Demand," *Petroleum Intelligence Weekly* XX, no. 24 (June 15, 1981): 1.

quickly. [14] The unpleasant experience of high oil prices for consumers during the oil boom period had the effect of encouraging them to reduce their oil consumption immediately and directly through oil conservation and the substitution of alternative energy sources.

The decline in oil consumption in the US during the second oil crisis was particularly striking. Morgan economists estimated that there was a 2.2 million b/d decline in oil consumption in the US during 1979-81 despite a 3% increase in economic activity. In contrast, there was only a 1 million b/d decline during the first oil crisis with a concurrent 2.2% decrease in economic activity. This huge decline in US oil consumption originated mainly as a consumer response to skyrocketing oil prices through conservation and oil substitution.[15] In 1983, *PIW* anticipated that demand recovery for oil would not rise as much as economic growth in the United States mainly due to past price increases and ongoing conservation measures,[16] and this prediction came to fruition, recording, respectively, 2.2% increase in oil demand and 7.3% of GDP growth in 1984.[17] As in the case of the US, economic recovery had limited effect on boosting oil demand because high prices had induced conservation and oil substitution, the main reasons for the drop

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[14] "Economic Recovery May Have Limited Impact on Demand," *Petroleum Intelligence Weekly* XXII, no. 23 (June 6, 1983): 1.

[15] "Conservation Seen Driving Force," 1-2.

[16] "US Oil Demand Seen Growing Slower than Economy in 1984," *Petroleum Intelligence Weekly* XXII, no. 46 (November 14, 1983): 7.

[17] F. R. Parra Associates and Middle East Economic Survey, "International Crude Oil Prices: Major Time Series from the 1960s to 1991," (Nicosia, Cyprus: Middle East Petroleum and Economic Publications, 1993). See Table 10-4: World Bank, "World Data Bank: World Development Indicators," The World Bank, http://databank.worldbank.org/data/views/variableSelection/selectvariables.aspx?source=world-development-indicators (accessed November 21, 2013).

in demand in the 1980s.

In spite of the decline in demand in the US during the early 1980s, domestic oil production paradoxically increased, while imports dropped considerably. Oil demand in the United States, the biggest oil consuming country in the world, plunged 12.2% in the first quarter of 1980, resulting in a 9% drop in imports, although it continued to build up its record stocks with the increase of 20.2%. US oil imports continued to slide at a rapid pace, marking a 21.6% plunge for June and a 17.9% drop for the total second quarter of 1980.[18] According to figures from the American Petroleum Institute (API), total oil imports for 1980 plunged 18.2% to 6.8 million b/d, recording reductions of 25.3% and 23.5% in the third and fourth quarters. However, domestic crude production slightly rose 1.1% in same year due to the increase of Alaskan North Slope output and the slow rate of decline in the lower 48 states.[19] US oil imports were only 5.7 million b/d in 1981, a drop of about one-third from 1979, largely due to a third year of falling demand and substantial inventory withdrawals, while production in the lower 48 states rose steadily.[20] After the slight increase in US oil demand in 1984, growth in demand came to a complete halt in the first quarter of 1985. While US imports plunged in this period, removing 1.1 million b/d of US oil imports, US domestic supplies increased slightly because of

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[18] Petroleum & Energy Intelligence Weekly, "What's New around the World: U.S. Oil Imports Fall 9% as Demand Plunges 12%," *Petroleum Intelligence Weekly* XIX, no. 19 (May 12, 1980): 11; "What's New around the World: U.S. Oil Demand and Imports Continue to Slide," *Petroleum Intelligence Weekly* XIX, no. 30 (July 28, 1980): 11.

[19] "What's New around the World: U.S. Oil Imports Fall at Record Rates in 1980," *Petroleum Intelligence Weekly* XX, no. 4 (January 26, 1981): 9.

[20] "U.S. Oil Output Finally Halts 8-Year Decline in 1981," *Petroleum Intelligence Weekly* XXI, no. 4 (January 25, 1982): 7.

increases in output both in Alaska and in the lower-48 states, and refiners drew down inventories considerably. The huge decrease in oil imports was one of the major causes of price volatility in this period.[21] Although total US oil demand dropped considerably from 17.1 million b/d in 1980 to 15.7 million b/d in 1985, production rose slightly from 10.2 million b/d in 1980 to 10.6 million b/d in 1985. As a result, US oil imports decreased dramatically from 6.4 million b/d in 1980 to 4.0 million b/d in 1985, more than the decrease in oil demand.[22]

The decline in demand for oil in the United States, combined with increased domestic production and destocking in the first half of the 1980s, must have dealt a fearful blow to OPEC's production. US oil imports rose almost 25% during the first half of 1984, because of the slight increase in demand in 1984. The figure declined by 10% in the July-September period, marking a 9.6% import growth for the first nine months due to increased US oil production and the destocking of inventories in this period.[23] Despite the small growth in total US imports in 1984, OPEC's share of US crude oil imports during this period declined for the third consecutive year. However, imports from non-OPEC exporters rose 2.3% in 1984, accounting for almost two-thirds of overall imports

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[21] "US Import Plunge is Major Factor in World Oversupply," *Petroleum Intelligence Weekly* XXIV, no. 16 (April 22, 1985): 5.

[22] F. R. Parra Associates, "The International Oil Industry." See Table 3-4, 3-5, 12-3, 13-4, and 13-5.

[23] Petroleum & Energy Intelligence Weekly, "What's New around the World: US Oil Keeps Rising but Imports Fall," *Petroleum Intelligence Weekly* XXIII, no. 43 (October 22, 1984): 7.

by the end of the year.[24] The decline in demand had more direct impact on US imports from OPEC members. In particular, Saudi Arabia's oil exports to the United States plunged from 1.25 million b/d in 1980 to 0.13 million b/d in 1985.[25] Saudi Arabia was the biggest loser in the US market, absorbing about 50% of the cuts in US oil imports.

The decrease in oil demand became the new norm during the first half of the 1980s, threatening OPEC's predominant position in the oil market. The general anticipation of a bright future for the oil market in the late 1970s changed dramatically within two years, making the possibility of supply disruption highly unpredictable. Many oil experts begun to contemplate the possibility of a fundamental shift in the world supply/demand balance by early 1981, regarding the slide of spot crude oil prices as an indication of a weak market.[26] Under the widespread expectation of a further drop in demand for 1982, *PIW* anticipated in early 1982 that OPEC might try to regulate or allocate production among its members, if declining oil demand seemed likely to continue for any significant amount of time.[27] Before long, as *PIW* had anticipated, OPEC decided to apportion its output among its members in March 1982 and the declining trend in oil demand continued during the first half of the 1980s. As Daniel Yergin remarked, "in a complete reversal of the 1970s, producers now had to worry about

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[24] "OPEC's Share of U.S. Oil Supply Keeps on Falling," *Petroleum Intelligence Weekly* XXIV, no. 8 (February 25, 1985): 4-5.

[25] F. R. Parra Associates and Middle East Economic Survey, "International Crude Oil Prices." See Table 136.

[26] Petroleum & Energy Intelligence Weekly, "Falling Oil Demand Leans Momentum to Spot Crude Slide," *Petroleum Intelligence Weekly* XX, no. 6 (February 9, 1981): 2.

[27] "Soft Oil Demand Likely to Constrain 1982 OPEC Volume," *Petroleum Intelligence Weekly* XXI, no. 1 (January 4, 1982): 3-5.

their access to markets, rather than consumers about their access to supplies."[28] A weak market situation dramatically changed the balance of power between the oil producing countries and the oil-consuming countries in favor of the latter during the 1980s. The dramatic change in world oil demand was enough to challenge OPEC's capacity to set oil prices. The oil-consuming countries did not need to rush to buy over-valued oil, but simply needed to wait for offers from oil producing countries with discount prices. As a result, the bargaining power of the oil-consuming countries vis-à-vis OPEC members improved considerably, and they began to take the opportunity to break down the second oil price regime led by OPEC.

Although the decreasing demand for oil was not a temporary phenomenon, OPEC members still seemed to be indulging in utopian dreams of a future oil market by imposing high prices on consumers in the early 1980s. In early 1982, when OPEC was experiencing a serious drop in demand and was obliged to introduce an output-sharing program, most high officials in the organization still believed that demand would recover in the near future. They did not fully comprehend the effects of the price shocks of the 1970s on the structural changes of the world oil market in the 1980s. At the second Arab Energy Conference in March 1982, Dr. Ibrahim, the director of OAPEC's Economics Department, justified gradual but steady price increases for industrial consumers to reduce the energy growth rate to manageable levels, particularly because of the anticipated huge rise in energy consumption in the Arab world.[29] Many OPEC officials seemed to regard all theses changes as temporary phenomena and were greatly over-

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[28] Yergin, *The Prize*, 721.

[29] Petroleum & Energy Intelligence Weekly, "OAPEC Warns Arabs Must Curb Oil Demand Growth," *Petroleum Intelligence Weekly* XXI, no. 11 (March 15, 1982): 6.

optimistic about the future of the oil market. They did not fully understand how the decreasing demand for oil, particularly for OPEC's oil, would fundamentally change the power balance between the oil consuming and the oil exporting countries, allowing the former to have more room to maneuver in the world oil market at the expense of OPEC. Before long, OPEC members would be obliged to pay serious attention to the fall in oil demand.

The Increase of Non-OPEC Production

High oil prices in the 1970s encouraged oil exploration in non-OPEC countries, which usually involved higher costs in comparison with those of OPEC members, but which gradually undermined OPEC's market share. In November 1979, non-OPEC output in the free world hit 17.9 million b/d, with Mexico reaching a record 1.6 million b/d and North Sea production surpassing 2 million b/d.[30] Total OPEC production for 1979 was 30.8 million b/d based on total production capacity of 35.2 million b/d. Despite OPEC's 3.1% production gain for 1979, its market share of total free world oil production dropped from 64.2% in 1978 to 63.5% in 1979. OPEC's market share had been declining steadily since 1976, when it accounted for 68% of total free world oil production.[31] According to *PIW's* calculations, OPEC oil production in 1981 recorded its sharpest drop ever, plunging 4.4 million b/d to 22.5 million b/d. For the first time in two decades, OPEC's output fell behind the rest of the free world in 1982. The increasing

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[30] "What's New around the World: Rise in Non-OPEC Output Boosts World Total," *Petroleum Intelligence Weekly* XIX, no. 2 (January 14, 1980): 9.

[31] "OPEC Output Helps Raise Free World Total to New Record," *Petroleum Intelligence Weekly* XIX, no. 5 (February 4, 1980): 1.

production of the non-OPEC free world was largely due to increases in Mexico and the North Sea. Each producer recorded yearly averages of 2.7 million b/d in 1982, higher than the production of any OPEC country except for Saudi Arabia.[32]

While OPEC countries enjoyed high oil prices by applying premiums and surcharges to their crude in the late 1970s and the very early 1980s, they never anticipated that the increasing production of the non-OPEC countries would undermine their basic ability to set oil prices at will. Regardless of the increase in non-OPEC production, OPEC members were principally concerned with future scarcity during this period. Their main concern was not the decreasing market share but the conservation of their oil resources for future generations. The 55th OPEC Conference in December 1979 clearly showed the conservationist attitude of OPEC members with regard to their oil: "the Conference agreed that it is necessary for all Member Countries to adopt internal energy policies that take into account the ever increasing scarcity of our exhaustible oil resources."[33] This conservationist tendency within OPEC continued into the next year, as noted in a statement by Iraq on the occasion of the 20th anniversary of OPEC: "this wealth is a depletable one and does not belong to the present generation of their peoples alone, but also to future generations."[34] In spite of the decreasing market share of OPEC, most member countries adopted a conservationist stance towards their oil production

[32] "OPEC's Oil Output Falls, Turning Back the Clock to 1969," *Petroleum Intelligence Weekly* XXI, no. 8 (February 22, 1982): 1; "Non-OPEC Output Supplied over Half 1982 Free World Oil," *Petroleum Intelligence Weekly* XXII, no. 9 (February 28, 1983): 1; There are small differences between *PIW's* data and F. R. Parra Associates; however, these were negligible as they show similar trends in prices and production.

[33] OPEC, *Official Resolutions and Press Releases*, 170.

[34] Ibid., 187.

during the second oil crisis. Few people within OPEC expected that this gradual change would suddenly challenge the organization's position as a price setter in the world oil market. They acted as if their dominant power in the oil market would continue without any interference from other producers.

The apparent indifference of OPEC members towards their decreasing market share was possible because unprecedentedly high oil prices were sufficiently large for them to compensate for their decreasing market share with huge financial surpluses. Because of the tight market situation and the high oil prices during the second oil crisis, OPEC members reaped windfall profits from oil revenues in spite of the continuing decrease in their market share. In a relatively short time, OPEC's total oil revenues soared up dramatically over two times from 114.341 billion in 1978 to 275.028 billion in 1980.[35] Furthermore, the evident strength of the US dollar on foreign exchange markets enhanced OPEC's purchasing power. In August 1981, one barrel was worth 15% more to OPEC than it was in January. The appreciated value of oil dollars also compensated for the loss of contract sales volumes for OPEC members, allowing them to continue to take a hard line on oil prices.[36] This economic bonanza was big enough for them to ignore the fact that the market share of non-OPEC producers was increasing at their expense. They were intoxicated with what they interpreted as the joy of victory in the world oil market by achieving high oil prices and the subsequent huge financial surplus. OPEC members did not need to worry about the increasing output of non-OPEC countries, because the

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[35] Middle East Petroleum and Economic Publications, "Some Tables from OPEC Statistical Bulletin 1983," *Middle East Economic Survey* XXVIII, no. 10 (December 17, 1984): D4.

[36] Petroleum & Energy Intelligence Weekly, "Dollar Strength Cushioning OPEC in Oil Price Showdown," *Petroleum Intelligence Weekly* XX, no. 31 (August 3, 1981): 1.

effect of this growth on the economies of OPEC member countries was negligible.

The declining trend of OPEC's output became clear in early 1981. Less than two years after the 1979 oil crisis, the general prospect for OPEC output changed dramatically, indicating that it may have reached a historic high and might now decline indefinitely. The sixteen-fold increase in oil prices during the 1970s made the prospect for the important role of OPEC oil in the future oil market much more doubtful, mainly because extraordinarily high oil prices had brought about a huge cut in oil demand and consequently made the expansion of OPEC's output capacity unnecessary.[37] In 1981, a study by Wood, Mackenzie, an Edinburgh investment firm, projected that non-OPEC suppliers would provide over 50% of the free world's oil in 1982 and that demand for OPEC oil would likely not recover until the second half of 1982. Under these unfavorable circumstances, the study indicated a negative perspective for the continuing existence of OPEC as an effective body.[38] When OPEC members were dreaming of a rosy future oil market through the acquisition of huge financial profits from high oil prices in 1981, some studies outside OPEC began to notice signs of structural changes in the world oil market and came to pessimistic conclusions about the future of the oil market, which would damage OPEC's output and might even endanger its existence.

In contrast to the conservationist attitude of OPEC members, market conditions in 1981 indicated that their concerns over the rapid depletion of their oil were both redundant and illogical. In 1981, the rate of oil discovery eclipsed oil consumption for the

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[37] "Falling Demand May Keep OPEC's Output in Decline," *Petroleum Intelligence Weekly* XX, no. 3 (January 5, 1981): 5.

[38] "Non-OPEC Nations Now Main Source of Free World Oil," *Petroleum Intelligence Weekly* XX, no. 31 (August 3, 1981): 6-7.

first time in a decade. According to a report by the London investment firm Panmure Gordon & Co., the combination of falling demand and rising exploration considerably lengthened the estimated life of proven free world reserves from 28.8 years in 1973 to 35.5 years in 1981. In particular, spectacular quantities of oil were discovered in non-OPEC countries, exceeding the consumption of the whole free world, including OPEC, in 1981. Between 1971 and 1977, newly discovered oil in non-OPEC countries only accounted for half of free world consumption. In addition to rising non-OPEC reserves, the growth in OPEC's unused production capacity led the study to anticipate the high possibility of falling prices in the near future and to be pessimistic about the possibility of an inexorable oil price escalation, as had happened during previous oil crises that had been triggered by political events in OPEC countries.[39]

The price competitions initiated by the application of relatively moderate prices on the part of non-OPEC suppliers, and their increasing production, helped OPEC reach price reunification in October 1981, and also led to OPEC prices moving downwards. Light crudes, particularly from the North Sea, usually competed with African OPEC crudes from Algeria, Libya and Nigeria. In early 1981, North Sea producers applied a more moderate $3 a barrel rise rather than pushing prices to the upper limits set by African OPEC countries.[40] The British National Oil Company (BNOC) became a price leader in the oil market in early June 1981 as it proposed a $2 cut to $37.25 a barrel for the British North Sea Marker Crude. Before this preemptive action, BNOC usually

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[39] "Oil Dicovery Rate Eclipses Use for First Time in Decade," *Petroleum Intelligence Weekly* XX, no. 45 (November 9, 1981): 7-8.

[40] "North Sea Prices Seem to Be Tracking Algeria, Nigeria," *Petroleum Intelligence Weekly* XX, no. 2 (January 12, 1981): 4.

waited for African OPEC producers to set oil prices before it followed suit. In reaction to BNOC's proposed price cut, buyers offered counter-proposals ranging from $34 to $35.25 a barrel.[41] BNOC finally decided to peg its North Sea pricing structure to $32 a barrel Saudi Arabian Light crude as of June 15 with the consideration of a $3 a barrel quality and location differential above the Arab Light base. The decision, which broke the traditional link with African crude oil prices, resulted in setting BNOC's North Sea "marker" at $35 for a primary Forties and Sullom Voe Brent Blend Crude. Britain became the only major exporter supporting Saudi Arabia's $32 price instead of the $36 OPEC marker requested by the African producers.[42] After the price cut from the British North Sea in June 1981, Nigeria was faced with serious financial problems, suffering from declining oil exports and rapidly shrinking foreign exchange, and it was under great pressure to reduce its official prices to recover its oil revenues.[43] Its oil production dropped dramatically from 1.35 million b/d in June 1981 to 0.77 million b/d in July 1981 and 0.71 million b/d in August 1981.[44] Nigeria regarded a $10 billion foreign reserve as its minimum requirement, but by late August, its reserve had fallen to less than $7 billion,

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[41] "BNOC Becomes Price Leader Instead of Follower," *Petroleum Intelligence Weekly* XX, no. 24 (June 15, 1981): 4.

[42] "Thanks to Britain Saudis No Longer Alone on $32 Base," *Petroleum Intelligence Weekly* XX, no. 25 (June 22, 1981): 5.

[43] "Drop in Oil Exports Posing Financial Dilemma for Nigeria," *Petroleum Intelligence Weekly* XX, no. 31 (August 3, 1981): 3.

[44] "PIW's Month-by-Month Breakdown of Total World Crude Oil and NGL Production for 1981," *Petroleum Intelligence Weekly* XXI, no. 8 (February 22, 1982): 5.

due largely to the reduction in oil sales.[45] To recover its oil exports, Nigeria finally applied a 10% discount, a reduction of $4 a barrel, to its crude oils on August 26, 1981. This decision did not challenge the OPEC price structure, which specified prices of OPEC crudes in the range between $36/b and $41/b at the 59th Bali Conference in December 1980.[46] Before long, Nigeria cut prices again in another attempt to regain lost customers, causing the disruption of OPEC's previous price decision. Nigeria cut contract crude oil selling prices a further $1.50 a barrel to $ $34.50, retroactive to October 1.[47] However, the price cut in October was short-lived. Soon after the OPEC meeting in Geneva on October 29, 1981, which resulted in the setting of the official price of Marker Crude at $ 34 per barrel effective no later than November 1, 1981, Nigeria was obliged to raise its oil prices from $34.50 to $36.50 per barrel because of a reflection of $2.5 market price differentials against the marker for its oil.[48] In the face of price competition from non-OPEC suppliers, particularly the North Sea producers, OPEC's decision in October could not satisfy the African producers. While African OPEC producers' exports to the United States dropped sharply in 1981, by 23% for Nigeria, 33% for Libya and 41% for Algeria, the United Kingdom's exports increased 136% in 1981 over the previous year.[49]

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[45] "Is Nigeria Price Cut a 90-Day Wonder? Oil Buyers Ask," *Petroleum Intelligence Weekly* XX, no. 43 (October 26, 1981): 1.

[46] "Nigeria Price Cut May Help Speed OPEC Reunification," *Petroleum Intelligence Weekly* XX, no. 35 (August 31, 1981): 3-4.

[47] "Is Nigeria Price Cut," 1.

[48] "OPEC Price Unity Faces Its Real Test in Oil Markets," *Petroleum Intelligence Weekly* XX, no. 44 (November 2, 1981): 1, 4.

[49] "Mexico and UK Now among Top U.S. Crude Sources," *Petroleum Intelligence Weekly* XXI, no. 13 (March 29, 1982): 8.

The remarkable expansion of market share of the non-OPEC suppliers, based on their moderate oil prices, kept putting pressures on OPEC to reduce its marker price and to rearrange price differentials among member countries during the 1980s.

Non-OPEC price competition and its increasing market share encouraged the introduction of production quotas among OPEC members with a ceiling of 18 million b/d and the readjustment of the price differential in March 1982 to defend OPEC's marker price. BNOC's two-stage $5.50 per barrel price cuts in early 1982 put OPEC in the difficult position of having to defend the marker price of $34 in Mach 1982 and consequently helped spur the introduction of an OPEC production agreement for the first time in its history.[50] At the Vienna meeting on March 20, 1982, OPEC decided that the price differential for the light and extra light crudes in relation to the Marker Crude should be set at the same levels as in 1978. This decision allowed average price reductions of 55¢ on OPEC crude oils without cracking the $34 marker price under the pressure of lowering OPEC's oil prices. As a result, Nigeria reduced the price for Bonny Light Crude Oil from $36.5 to $35.5 per barrel.[51] However, Nigeria's price cut was not big enough for the companies in Nigeria to produce more oil. To defend the $34 base price structure and stabilize the oil market, it was important that the core membership of OPEC should prevent Nigeria from setting big price cuts for the recovery of its reduced sales. Therefore, OPEC's Gulf oil producing states, particularly Saudi Arabia and Kuwait, put intense pressure on the major oil companies, threatening the more recalcitrant with

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[50] "British Price Cut Leaving next Move up to OPEC," *Petroleum Intelligence Weekly* XXII, no. 8 (February 21, 1983): 4.

[51] "New Differentials Cut OPEC Prices Only 55¢ a Barrel," *Petroleum Intelligence Weekly* XXI, no. 13 (March 29, 1982): 5.

sanctions if they continued drastic off-take reductions.[52] Mainly because of OPEC's collective efforts to sustain its own price structure, spot prices began to overtake official OPEC price levels in early May 1982 for the first time since January 1982 and Nigeria's contract crude customers increased their liftings in Nigeria almost to its allocated 1.3 million production quota.[53] The restoration of the official price was followed by a relapse, but OPEC again succeeded in setting the price at $34 per barrel in September. This achievement must have given OPEC members self-confidence that they would succeed in defending the marker price of $34 per barrel by managing spot prices effectively through appropriate production adjustments. However, apparently intoxicated with their achievements, members of OPEC began to break their quotas, and to produce more than their allocations, and spot prices began to decline in late 1982 and early 1983.[54] OPEC's psychological victory did not last long.

With these downward spot price trends, the continuing price competition between the North Sea crudes and OPEC's African crudes contributed to a drop in OPEC's Marker Crude price for the first time in its history. In a slack market situation, it became clear that any decision to cut oil prices in the North Sea would soon lead to price reductions from the African oil producers, particularly struggling Nigeria, because of

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[52] "Companies Buy Time but Not Much Oil in Nigeria," *Petroleum Intelligence Weekly* XXI, no. 14 (April 5, 1982): 2; "Will OPEC's Tactics on Nigeria Create New Confrontations?" *Petroleum Intelligence Weekly* XXI, no. 14 (April 5, 1982): 3-4.

[53] "Oil Buyers' Return Lifts Nigeria Output from March Low," *Petroleum Intelligence Weekly* XXI, no. 20 (May 17, 1982): 2; "Spot Crude Market Now Overtaking Official Price Levels," *Petroleum Intelligence Weekly* XXI, no. 20 (May 17, 1982): 4.

[54] Fereidun Fesharaki and Hossein Razavi, "Spot Oil, Netbacks and Petroleum Futures: The Emergence of a New Oil Market," in *Special Report* (London: The Economic Intelligence Unit, 1986), 73.

their desire to maintain competitive output levels. As Robert Mabro noted in a special supplement to *PIW*, "there is a clear transmission chain from the North Sea to Nigeria, then to the other African producers."[55] In February 1983, the announcement by BNOC that it would cut its crudes \$3 to \$3.5 a barrel entailed an immediate price cut in Nigerian oil, Bonny Light Crude, by \$5.5 a barrel, much more than market expectations. Therefore, the price competition between these two countries led Saudi Arabia to reduce Marker Crude from \$34 to \$29 a barrel with a new ceiling of 17.5 million b/d at the OPEC Conference in London on March 14, 1983. Before the meeting, Saudi Arabia had envisaged \$30 a barrel, but the price war initiated by BNOC's price cut obliged it to reduce its oil price \$1 further to \$29 a barrel.[56] Because of this price cut, the differentials of \$1.5 a barrel for other African crudes in Libya and Algeria resulted in a new price level of \$30.5 a barrel. However, as Nigeria had already reduced its Bonny Light crude price to \$30 a barrel before the meeting, the OPEC communiqué had to make an exceptional case for the price differential of Nigerian oil:[57] "to maintain the existing differentials among the various OPEC crudes at the same level as agreed upon at the 63rd (Extraordinary) Meeting of the Conference held in Vienna, Austria, in March 1983, with the temporary exception that the differentials for the Nigerian crudes should be US \$1

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[55] Robert Mabro, "OPEC's Future Pricing Role May Be at Stake: Special Supplement," *Petroleum Intelligence Weekly* XXI, no. 16 (April 19, 1982): 4.

[56] Petroleum & Energy Intelligence Weekly, "What's New around the World: Nigeria's New Price Terms Also Cut Equity Oil Costs & Here are the Latest Cuts in Official Crude Oil Prices," ibid.XXII, no. 9 (February 28, 1983): 11-12. For more details of this event, see Terzian, *OPEC*, 315-20.

[57] Ian Seymour, "OPEC: Back in the Driver's Seat?" *Middle East Economic Survey* XXVI, no. 23 (March 21, 1983): A2.

over the price of the Marker Crude."[58] The increasing influence of non-OPEC countries over the world oil market made it more difficult for OPEC to set oil prices at its own will, especially in ways which would satisfy all OPEC members.

Since early 1983, it became inevitable that OPEC members would try to secure cooperation from non-OPEC countries for the stability of the oil market and the maintenance of OPEC's entire price structure. Comments on "non-OPEC" for the first time in an OPEC communiqué on March 14, 1983 clearly revealed the urgency of securing their cooperation, saying, "The conference welcomed the co-operative efforts of some non-OPEC exporters in resolving the present difficulties."[59] OPEC could no longer ignore non-OPEC producers for the successful implementation of its oil policy. Non-OPEC suppliers successfully made inroads into the world oil market at the expense of OPEC by applying relatively low oil prices. Seymour argued in *MEES* that "the chances of success for the OPEC price stabilization program are dependent to a large extent on some degree of cooperation from the major-non-OPEC oil exporting countries."[60] Without forging a degree of amicable cooperation from the non-OPEC producers, particularly Britain, it became clear that OPEC's whole price structure would be in danger, with a possible price collapse in the near future.

Although OPEC tried to gain the cooperation of the non-OPEC producers by various means, it failed to receive full support from them. Its decision to cut oil prices in March 1983 did attract a more cooperative position on prices from the major non-OPEC

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[58] OPEC, *Official Resolutions and Press Releases*, 208.

[59] Ibid., 209.

[60] Seymour, "OPEC," A6.

producers. However, it was not able to acquire any meaningful output restrictions from them, except for Mexico, which showed its alignment with the OPEC producers by introducing an export ceiling of 1.5 million b/d during the second quarter of 1983.[61] As both a producer and consumer, Britain seemed to be satisfied with OPEC's relatively moderate price cut in March 1983. Presenting the budget to Parliament on 14 March, the Chancellor of the Exchequer, Sir Geoffrey Howe, said, "of course lower oil prices reduce the value of our own oil production. But North Sea oil accounts for only 5% of our national income and tax on it for only some 6% of government revenues." Acknowledging that "sharp swings in the oil price are in no one's interest," he said that "a fall in oil prices would be benefit to the world economy and through it the UK, and is therefore to be welcomed."[62] In reaction to the OPEC price cut in March 1983, BNOC decided to cut its oil prices to levels acceptable to the Gulf exporters.[63] However, in terms

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[61] Nordine Ait Laoussine et al., "Stability and Oil Prices: Holding the Line," ibid.Supplement to XXVI, no. 50 (September 26, 1983): 4.

[62] Middle East Petroleum and Economic Publications, "OPEC: Reaction to the OPEC Price Cut," ibid.XXVI, no. 23 (March 21, 1983): A10.

[63] On March 30, 1983, Britain proposed the price moves, contriving to avoid provoking OPEC retaliation, particularly any countermove by Nigeria, while keeping BNOC's customers satisfied. In effect from 1 March, Britain changed the marker to Brent crude from the previous marker Forties, mainly because Brent accounted for the largest quantity of output and trade among the UK North Sea crudes, and this decision gave BNOC the opportunity to downgrade the other crudes further. While the Brent Marker Crude was reduced by 50¢ to $30/b, all other crudes were lowered by 75¢, which resulted in lowering Forties to $29.75/b. As a result, British Petroleum (BP), the owner of Forties won a slight advantage over its chief UK marketing rivals, Shell and Exxon, the main producers of Brent Blend, because the change effectively removed BP's previous North Sea disadvantage. OPEC in general and Nigeria in particular welcomed this decision. See "OPEC/Nigerian Acceptance of New UK Price Raises Hopes for Stabilization of Oil Market," *Middle East Economic Survey* XXVI, no. 25 (April 4, 1983): A1-A3; Petroleum & Energy Intelligence Weekly, "Setting Differentials is No Easy Task in North Sea Either," *Petroleum Intelligence Weekly* XXII, no. 15 (April 11, 1983): 7.

of oil production, British officials made it clear that polite consultations with OPEC would not bring about major cuts in Britain's output.[64] Like the UK, Norway aligned its prices to the new OPEC price structure in April 1983 without any undertakings to restrict output. The Soviet Union also took full advantage of OPEC's role in stabilizing the oil market without participating in voluntary output restrictions.[65]

In addition to the increasing production of non-OPEC producers, OPEC's output above its ceiling since July 1983 put the oil market in surplus during the summer of 1984, putting high pressure on both non-OPEC and OPEC to reduce prices. Given the general recovery of the oil market since the summer of 1983, non-OPEC output increased from 20.7 million b/d in June 1983 to 21.5 million b/d in June 1984, a 4.2% rise.[66] In the summer of 1984 there was a surplus in the oil market. OPEC blamed the non-OPEC producers for the deterioration in the stability of the market and asked for their cooperation in restoring it, saying in OPEC's official communiqué on July 11, 1984:

> The Conference noted that the increased production from oil-exporting countries, non-Members of OPEC, had greatly contributed to the recent market situation and decided to establish contacts with those countries, with a view to finding ways and means of enhancing co-operation between OPEC and those countries, in a joint effort to shoulder the responsibility of stabilizing the oil market and defending the oil price structure.[67]

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[64] "OPEC Makes Start on Dialogue with Other Oil Exporters," *Petroleum Intelligence Weekly* XXII, no. 9 (February 28, 1983): 2.

[65] Laoussine et al., "Stability and Oil Prices," 4-5.

[66] Petroleum & Energy Intelligence Weekly, "PIW's Month-by-Month Breakdown of Total World Crude Oil and NGL Production for 1983," *Petroleum Intelligence Weekly* XXIII, no. 7 (February 13, 1984): 6; "PIW's Estimated Tally of Month-by-Month World Crude Oil and NGL Production for 1984," *Petroleum Intelligence Weekly* XXIV, no. 7 (February 18, 1985): 6.

[67] OPEC, *Official Resolutions and Press Releases*, 216-17.

In fact, however, the non-OPEC countries were not the only producers threatening OPEC's price structure and the stability of the market by producing more oil. Since July 1983, OPEC had produced more oil than its ceiling of 17.5 million b/d until July 1984, causing a fall in the surplus.[68] Although OPEC did not specifically mention that members were cheating on their production quotas, the organization did acknowledge their misbehavior by putting unprecedented emphasis on the need for discipline, solidarity, and responsibility towards the world oil situation on the part of OPEC members in a communiqué in July 1984.[69]

In the face of a glut on the oil market and dropping spot prices during the summer of 1984, OPEC could heave a sigh of relief for a little while after securing ad hoc cooperation from non-OPEC, particularly Britain, in sustaining OPEC prices. It was generally believed that there was fairly open cooperation between the UK, Mexico and Egypt to protect the official $29 pricing against the increasing influence of the spot market. In August 1984, Alick Buchanan-Smith, the British Minister of Energy, sent eight major BNOC customers an unprecedented official letter to ask them to avoid pressuring the national crude market into price cuts, because a BNOC-triggered price collapse would bring a huge drop in North Sea tax revenue and investment.[70] In reaction to the British government's pro-OPEC behavior, the *Financial Times* mentioned on August 13, 1984 that "this is the first time the British Government directly (if

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[68] Petroleum & Energy Intelligence Weekly, "PIW's Month-by-Month Breakdown for 1983," 6; "PIW's Estimated Tally for 1984," 6.

[69] OPEC, *Official Resolutions and Press Releases*, 216.

[70] Petroleum & Energy Intelligence Weekly, "Non-OPEC Suppliers Showing Support for Price Structure," *Petroleum Intelligence Weekly* XXIII, no. 32 (August 6, 1984): 1, 5.

clandestinely) attempted to act as a fourteenth member of OPEC by pressing oil companies to keep the price of oil higher."[71] However, it is not quite the case that the British government stood enthusiastically behind OPEC at that time. According to *PIW's* analysis, it was most likely that the British government was primarily interested in avoiding a price collapse initiated by its own decision to cut prices, and misread the market fundamentals by seeing the surplus as temporary.[72]

The British manipulation of the market came at a price. Part of BNOC's statutory duty was to buy 51% of all North Sea production at term price. Because the term price imposed by BNOC was higher than the spot price in this period, the oil companies increasingly turned away from BNOC as a long-term supplier of oil, thus obliging it to sell large volumes of crude at a loss on the spot market. The volume was approximately 200,000 b/d and BNOC was losing up to $300,000 a day with North Sea spot prices of $28.50 in early October.[73] When Britain realized that BNOC's $30 contract price in October had become fundamentally out-of-line with longer-term market trends and was causing the corporation huge financial losses, it could not oppose strong market pressures.

A price cut by the Norwegian state oil company (Statoil) in the middle of October triggered consecutive price cuts from Britain and Nigeria, and these

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[71] The Financial Times Limited, "OPEC's Other Member," *Financial Times*, August 13, 1984, Section I; 8.

[72] Petroleum & Energy Intelligence Weekly, "British Commitment to OPEC Prices Remains Conditional," *Petroleum Intelligence Weekly* XXIII, no. 35 (August 27, 1984): 1-2.

[73] Dominic Lawson, "Defence of N. Sea Price Might Harm Trade, Says BNOC," *Financial Times*, October 1, 1984, Section I; 8.

developments compelled OPEC to reduce its production ceiling and to cut the price of Marker Crude. On October 12, 1984, Statoil secretly offered complex month-to-month discounts, reflecting spot prices, to retain term clients. Three days later this secret attempt became public and BNOC decided to cut its official prices by $1.35 a barrel on October 17. The next day, Nigeria followed suit by cutting its price by $2.0 per a barrel.[74] Because of the oil price panic initiated by Norway's price cut, OPEC, which was supposed to discuss an increase in its production ceiling in anticipation of a surge in winter demand, was obliged to reduce its production ceiling from 17.5 million b/d to 16 million b/d, a reduction of 1.5 million b/d, to defend its Marker Crude price of $29 per a barrel at the 71st OPEC Meeting on October 29-31, 1984.[75] To avoid unnecessary turmoil in the oil markets, BNOC and Statoil decided to wait for market developments and did not set their official prices until the OPEC meeting at the end of January. To bring Britain back under the OPEC pricing umbrella, the OPEC majority agreed to a $1 cut in Arabian Light to $28 per barrel and to a 50¢ rise in Arabian Heavy to $26.50 per barrel at OPEC's meeting on January 28-30, 1985.[76] The decision to reduce differentials between light crudes and heavier crudes was intended to satisfy Britain and Norway.[77] Both countries pointed to

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[74] Petroleum & Energy Intelligence Weekly, "Oil Price Fumbles Allow Spot Forces to Rule the Market," *Petroleum Intelligence Weekly* XXIII, no. 43 (October 22, 1984): 2-3.

[75] Terzian, *OPEC*, 329; OPEC, *Official Resolutions and Press Releases*, 220.

[76] Dominic Lawson, "OPEC Agrees New Price Levels and Monitoring System," *Financial Times*, January 31, 1985, Section I; 1.

[77] Alick Buchanan-Smith had already shown Britain's disappointment at the lack of full agreement on raising the base price of heavier crudes at OPEC's Geneva meeting in December 1984. See Maurice Samuelson, "Britain Rules out Early Cut in N. Sea Prices," ibid., January 2, 1985, Section I; 1.

their lack of competitiveness with Saudi crude, particularly after Saudi Arabia's decision to realign the export supply ratio to 40% light (previously 60% light) and 60% heavier crudes effective for October 1984, resulting in an immediate 50¢ a barrel reduction in Saudi oil.[78] In addition, Nigeria's Bonny Light was set from $28 to $28.65 per barrel by matching BNOC's official Brent price for the fourth quarter of 1984 in a bid to lead Britain to announce unchanged North Sea official prices.[79] However, all these efforts on OPEC's part were in vain. Following a similar decision by Norway in January, the British government decided to abolish BNOC and to shift its oil policy to monthly market-related prices in the middle of March.[80]

The remarkable growth in the production of non-OPEC members, and their increasing influence on the global oil market, not only gave them (the North Sea producers in particular) the key to sustain the OPEC price structure, but also increased their financial burden, which seriously challenged the solidarity of OPEC. During the first half of the 1980s, the non-OPEC countries emerged as a major influence on OPEC's pricing policies and this undeniable fact was clear from many OPEC communiqués, with their unprecedented calls on non-OPEC countries to cooperate with its oil policies. The growing power of the non-OPEC could only take place at the expense of OPEC production. While OPEC cut its production in an attempt to maintain its overall price

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[78] Petroleum & Energy Intelligence Weekly, "Saudi Supply Mix Considered the Key to Future Swing Role," *Petroleum Intelligence Weekly* XXIII, no. 42 (October 15, 1984): 3; "Oil Price Fumbles," 2.

[79] Lawson, "OPEC Agrees New Price Levels," Section I; 1.

[80] Middle East Petroleum and Economic Publications, "The Abolition of BNOC: A Destabilizing Influence?" *Middle East Economic Survey* XXVIII, no. 23 (March 18, 1985): A1-A2.

structure, non-OPEC countries simply increased theirs. [81] Even in 1984, when demand had recovered slightly, total annual 1984 OPEC production was 17.5 million b/d, nearly paralleling 1983 volume (down less than 1% from 1983). Non-OPEC countries, however, reaped most of the growth in demand by increasing their output by 5% to a total of 21.7 million b/d in 1984.[82] In particular, North Sea output grew around 11% in 1984, making Britain the world's fifth largest producer. In early 1985, non-OPEC countries accounted for 67% of the world's available oil.[83] As mentioned in the *Financial Times*, the reason that OPEC members were experiencing financial difficulties during the first half of the 1980s was not really the fall in the oil price since 1979, but dramatic decreases in production. In the case of Nigeria, after considering the appreciating dollar and adjusting for inflation, every barrel of oil it exported in early 1985 was priced at 15% more than it was in 1979, while it was selling 40% less than it was five years ago.[84] Because of a huge decline in OPEC's revenues, its members were often tempted to produce beyond their quotas. Particularly after the shift of non-OPEC countries' oil policies toward market-related oil prices in early 1985 without any restriction on production, which necessarily

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[81] Since July 1983, OPEC had produced more oil than its ceiling of 17.5 million b/d until July 1984. However, these production levels were lower than those in pervious years, while non-OPEC's production increased continuously. Although OPEC cut its production after July 1984 to sustain its price structure, the non-OPEC countries did not participate in similar restrictions.

[82] Petroleum & Energy Intelligence Weekly, "Ups and Downs in OPEC Output Even out at Year-End," *Petroleum Intelligence Weekly* XXIV, no. 7 (February 18, 1985): 5.

[83] "Non-OPEC Output Plays Still Bigger World Supply Role," *Petroleum Intelligence Weekly* XXIV, no. 1 (January 7, 1985): 7.

[84] Financial Times Limited, "The Need for Cheaper Oil," *Financial Times*, February 4, 1985, Section I; 12.

required a huge cut in OPEC's production, it became really hard to discipline OPEC members to observe their quotas. The failure to secure cooperation from non-OPEC countries and the undermining of their own solidarity accelerated the emergence of a new market-oriented price regime.

The Stockpiling of Oil Consuming Countries

While OPEC oil producers were exultant at the windfall of oil revenues from high oil prices during the boom period, the oil-consuming countries began to use oil stockpiling as security against any possible supply shortfalls or any attempt to rise prices to undesirable levels after the 1973-74 oil embargo. After the 1973 crisis, the IEA regarded stockpiling as its basic emergency-sharing program.[85] When supply shortages reached the 7% level, this would trigger IEA's emergency sharing system. In an attempt to meet supply shortages, the governments of the 21-nation IEA steadily accumulated their government stocks, which would be used to intervene in the event of a subcrisis.[86] After securing huge amounts of stocks, the oil-consuming countries could effectively cope with OPEC's unilateral oil polices by stockpiling and destocking during the first half of the 1980s.

Oil stocks can be classified in three different practical categories: minimum operating and obligatory, government strategic, and discretionary and seasonal stocks. During the first half of the 1980s, seasonal and government strategic stocks increased

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[85] Shwadran, *Middle East Oil Crisis*, 161.

[86] Petroleum & Energy Intelligence Weekly, "Government Stocks May Be Answer to IEA Sub-Crisis," *Petroleum Intelligence Weekly* XX, no. 42 (October 19, 1981): 5-6.

dramatically from 13% of total stocks in January 1979 to 33% in January 1985. More specifically, discretionary and seasonal stocks shrank from 26% of total stocks in January 1982 to 18% in January 1985, while government strategic reserves grew to 15% in January 1985 from 8% in January 1982. In general, government bureaucrats prefer the concepts of "minimum operating levels" and "emergency reserves." While a few countries like the United States segregate emergency reserves like the Strategic Petroleum Reserve (SPR) administratively and physically from the oil industry's own operating inventory, most other countries have physically amalgamated the emergency reserve into the oil industry's own operating inventory and either the industry itself or a special entity, usually a public corporation, finances and manages this emergency storage. As the industry's operational stock requirements fluctuate constantly in accordance with the market situation, it is not always easy to make a precise distinction between operating inventories and emergency reserves. [87]

After the Arab oil embargo of 1973-74, the US government adopted the SPR program as a form of protection against major supply disruptions. The program began in earnest when President Ford signed the Energy Policy and Conservation Act on December 22, 1975. The emergency oil reserve in the US began on July 21, 1977, when the first consignment of approximately 412,000 barrels of Saudi Arabian Light Crude was delivered to the SPR.[88] During the second half of the 1970s, the program actually failed to secure scheduled oil stockpiling. By the end of 1978, the US government was

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[87] "A Roadmap to World Oil Stocks in the 1980s: Special Supplement," *Petroleum Intelligence Weekly* XXIV, no. 6 (February 11, 1985): 1-2.

[88] Office of Fossil Energy, "Petroleum Reserves: Strategic Petroleum Reserve," U.S. Department of Energy, http://energy.gov/fe/services/petroleum-reserves/strategic-petroleum-reserve (accessed December 5, 2013).

supposed to have 250 million barrels for the SPR, but it had only secured 69 million barrels.[89] Because the SPR program lagged behind schedule, actual spending for the Reserve slipped in 1979, readjusting the longer-term Reserve goal from 1 billion barrels by 1985 to 750 million barrels by 1986.[90] When the oil market suffered from high prices and tight supplies, particularly after the Iranian Revolution, the US government gave up purchasing imported oil for the SPR, because of high cost and the possible deterioration of a tight market situation.[91] After the enactment of the "Energy Security Act (Public Law 96-294)" at the 96th Congress, which required the US government to fill the SPR at a minimum rate of 100,000 b/d, President Carter signed it into law on June 30, 1980. Stockpiling for the SPR was reactivated in September 1980 with the delivery of 3.6 million barrels of Dubai and Nigerian crude.[92] The continuation of the SPR program allowed the US government to hold almost 500 million barrels early in 1985, which was

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[89] U.S. Library of Congress, Congressional Research Service, *The Strategic Petroleum Reserve: History, Perspectives, and Issues*, by Robert Bamberger, CRS Report RL33341 (Washington, DC: Office of Congressional Information and Publishing, February 24, 2008), 3.

[90] Petroleum & Energy Intelligence Weekly, "Carter Disappoints Many with His Cuts in Energy Spending," *Petroleum Intelligence Weekly* XVIII, no. 5 (January 29, 1979): 2.

[91] "U.S. Halts Stockpile Buying until Prices and Supplies Ease," *Petroleum Intelligence Weekly* XVIII, no. 13 (March 26, 1979): 7; "U.S. Setting up Machinery for Sale of Strategic Stocks," *Petroleum Intelligence Weekly* XVIII, no. 34 (August 20, 1979): 4.

[92] "What's New around the World: United States," *Petroleum Intelligence Weekly* XIX, no. 39 (September 29, 1980): 12; Brandi Robinson, "GEOG (EME) 432 Energy Policy: History of Major Energy Policy Landmarks," John A. Dutton e-Education Institute, College of Earth and Mineral Sciences, Pennsylvania State University, https://www.e-education.psu.edu/geog432/node/116 (accessed December 5, 2013).

much larger than the stock of most oil companies.[93]

Stock drawdown played an important role in stabilizing the oil market after the outbreak of the Iran-Iraq War. The stocks of the oil-consuming countries were considerably expanded in 1980. Before the war, the July stocks of IEA members stood at 96 days of forward consumption compared with an average of 80 days on the same date in 1976-79.[94] The surplus above normal inventory was approximately 475 million barrels when the war broke out. Roughly 100 million barrels were possessed by the United States, 170 million by European states, and more than 65 million by Japan, with the rest spread elsewhere. In addition, there was an additional cushion of 175 million barrels in transit on tankers due to the common practice of "slow streaming" to save high-priced bunker fuel.[95] At the meeting in Brussels on November 27, 1980, the nine Energy Ministers of the European Economic Community (EEC) agreed to get oil companies to draw down their oil stocks to relieve the tensions caused by the shortfall in supplies. On December 8, 1980, the Energy Ministers of the IEA decided to cut 2.2 million b/d of oil imports, and drawing down stocks was one of the major measures used to achieve this goal.[96] The drawdown of oil inventory after the Iran-Iraq War began to drive spot crude prices below

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[93] Petroleum & Energy Intelligence Weekly, "A Roadmap," 4.

[94] "Stockpiling Crude Adds 20-25% a Year to Costs, Firms Say," *Petroleum Intelligence Weekly* XIX, no. 33 (August 18, 1980): 3.

[95] "Inventory Shrinkage Could Mean Supply Crunch by Mid-Year," *Petroleum Intelligence Weekly* XX, no. 1 (January 5, 1981): 4.

[96] "Europeans Push for IEA Accord on Stock Draw down," *Petroleum Intelligence Weekly* XIX, no. 49 (December 8, 1980): 4; "IEA Seeks Accords on Using Stocks to Curb Panic Buying," *Petroleum Intelligence Weekly* XIX, no. 39 (September 29, 1980): 2-3; "Still No Teeth in IEA Plans to Curb Crude Imports," *Petroleum Intelligence Weekly* XIX, no. 50 (December 15, 1980): 5.

Marker Crude prices by early 1981.[97] The turmoil in the market with the rise of spot prices caused by the Iran-Iraq War was short-lived. During the first half of 1981, tranquility was restored in the market, allowing spot prices to fall below official prices.[98] According to Pierre Terzian, three major factors contributed to the avoidance of a shortfall in oil supplies during this period: the increased production of Saudi Arabia, the contribution of new oil producing countries such as Mexico, Egypt and the North Sea producers to the oil market, and decreased oil consumption in Western countries.[99] However, he missed one major factor, destocking, which contributed to the stability of the international oil market in this period. It should be noted that the oil consuming countries effectively developed their own countermeasures against possible shortfalls in oil supply and high oil prices through mechanisms of stockpiling and destocking, which paid off on the outbreak of the Iran-Iraq War.

In contrast to most OECD countries, which drew down their inventories to avoid the supply shortages triggered by the Iran-Iraq War, the US continuously filled its inventories. Total world oil inventories dropped from 5.4 billion barrels in 1980 to 4.6 billion barrels in 1983. Company-held inventories across the world dropped more dramatically, from 5.2 billion barrels in 1980 to 4.0 billion barrels in 1983. However, government-held oil inventories increased to 0.6 billion barrels in 1983 from 0.2 billion barrels in 1980. While government stocks in Japan and Europe stayed at the same level

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[97] "Stock Liquidation," 1.

[98] "The ABCs of Measuring Oil Market Price Trends: Speical Supplement," *Petroleum Intelligence Weekly* XXII, no. 10 (March 7, 1983): 8. See, Monthly Spot and Official Prices for Three Key Crudes During 1980-82.

[99] Terzian, *OPEC*, 285.

during this period, the US SPR increased from 0.1 billion barrels in 1980 to 0.6 billion barrels in 1983.[100] More specifically, while most oil-consuming countries, particularly in the Pacific and European markets, reached their inventory peak in August 1980, the US reached its high-oil mark in late 1982, mainly because of the continuation of the SPR program. Without SPR, the US oil companies' stocks reached their peak in August 1980 as in the other markets.[101] This means that the US continued to fill the SPR at a rate higher than the amount of drawn down inventories from the oil companies during the early Iran-Iraq War. Soon after the war, there was widespread optimism among specialists that the oil supply situation would be manageable and oil prices would stabilize through early 1981, mainly because of the structural changes in the oil market.[102] A memorandum to James Edward, the Secretary of Energy, from William Clark, Assistant to the President for National Security Affairs, notes that SPR acquisition was closely related to broader foreign policy and national security interests.[103] All these comprehensive considerations might have led the US government to continue its SPR program even after the outbreak of the Iran-Iraq War. The Reagan administration accelerated the fill rate of the SPR to 292,000 b/d in 1981, and its inventory reached

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[100] Petroleum & Energy Intelligence Weekly, "Company Stockdraw Masks Big Rise in Strategic Stocks," *Petroleum Intelligence Weekly* XXII, no. 32 (August 8, 1983): 1-2. The data for 1983 in *PIW* (August 8, 1983) was under the assumption of a 1 million b/d stock draw. Japanese government stocks in 1980 were not available in the data.

[101] "A Roadmap," 3-4.

[102] "Iraq/Iran Cutoff Manageable Through Early '81, IEA Says," *Petroleum Intelligence Weekly* XIX, no. 43 (October 27, 1980): 5-6; "Falling Oil Demand Plus Stocks," 5-6.

[103] Memo, William P. Clark to James B. Edwards, April 17, 1982, folder "Oil (April 1982-June 1982)," box 81, Executive Secretariat, NSC: Subject File, Ronald Reagan Library.

239.4 million barrels in February 1982 in five SPR storage sites—one in Texas, four in Louisiana – with the goal of a 750 million barrel SPR containing light crude, 65% of which would be sour (i.e., high in sulphur content) and 35% of which would be sweet (i.e., low in sulphur content).[104] The US Department of Energy utilized the Defense Fuel Supply Center (DFSC) as its agent to purchase crude oil for the SPR program on the spot market through competitive procurements at prices considerably lower than the official selling price. Under the weak market situation, the continuation of competitive purchases on the spot market through DFSC was in the best interests of the United States.[105]

After stockpiling huge amounts of oil in the consuming countries, these countries' decisions to build up more stocks or to drawdown their inventories became a major factor influencing short-term oil price movements on the spot market. The growth of global stock levels in the oil market produced the new concept of a "hidden producer" or "hidden consumers" depending on its changes. Because of stockpiling, a hidden consumer emerged in late 1979, consuming over 20% of OPEC production in a few months. In 1982 and 1983, however, destocking from oil consuming countries transformed them into hidden producers whose output was as much as 40% of OPEC production. Because of the huge impact of stocks on the global oil market, inventory

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[104] Memo, Douglas J. Feith to John M. Poindexter, February 23, 1982, folder "Oil (January 1982-March 1982)," box 81, Executive Secretariat, NSC: Subject File, Ronald Reagan Library.

[105] Memo, Henry R. Nau to Danny Boggs, Jim Burnham, David Burns, David Denoon, Richard Furiga, Sam Hard, Fred Khedouri, Dennis O'Brien, Robert Pelletreau, John Penfold, Eleanor Savage, Henry Thomas, and William Witting, April 6, 1982, folder "Oil (April 1982-June 1982)," box 81, Executive Secretariat, NSC: Subject File, Ronald Reagan Library.

trends became a crucial indicator in anticipating oil price movements in the near future.[106]

The Emergence of Market Forces

The emergence of the second oil price regime, which clearly divided the oil market into sellers (mainly OPEC members) and buyers, required companies such as BP to be buyers and traders whose interests were more closely related to the spot market than to long-term contracts. After the nationalization of most of the oil companies in the oil exporting countries, particularly in the Middle East, oil companies that had once been highly integrated were obliged to seek more oil on the spot market and to secure their reserves in other parts of the world, because they had difficulty matching their supplies to anticipated demand.[107] The new era ushered in by the second oil price regime necessarily entailed the emergence of the spot market in the oil industry.[108]

At the microlevel, the increasing influence of oil traders over the international oil market contributed to the development of the spot market. After the 1973-74 oil crisis, oil companies began to establish trading subsidiaries as separate profit centers and the role of oil traders increased considerably in the global market, particularly on the spot market, although their numbers fluctuated in accordance with the market situation. When prices were volatile, more traders entered the market to gain increased margins. When prices stabilized, their activities slowed down and their main objective became survival rather

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[106] Petroleum & Energy Intelligence Weekly, "A Roadmap," 4.

[107] Yergin, *The Prize*, 722-23.

[108] The second oil price regime also encouraged the international oil companies to explore oil fields outside the OPEC countries, such as the North Sea. This major development contributed to the increase in non-OPEC production.

than profit seeking. In this process, a few large trading companies became predominant in the market and most of them were subsidiaries of oil companies.[109]

From a macrolevel perspective on the development of the spot market in the oil industry, the emergence of a new oil price regime controlled by market forces in the 1980s was a necessary outcome of the seemingly unstoppable global wave of neoliberal economic dogma. The United States tried to incorporate neoliberal economic practices into the oil market, and encouraged market forces to take the power of controlling oil prices from OPEC. The chronic state of stagflation during the 1970s encouraged this relentless path toward neoliberal practices in various policy fields by deregulating the economy. Neoliberalism as "government practice" was initiated with the help of Ronald Reagan, Margaret Thatcher and the Chicago School of economic thought. The theory is largely based on Adam Smith's view that the hidden hand of the market is the best means of maximizing the ability of human beings, since free-market logic can mobilize even the basest of human instincts such as gluttony, greed, and the desire for wealth and power for the benefit of all. Therefore, it is natural that neoliberal doctrine, a theory of political economic practice, is opposed to any form of state intervention,[110] and the oil market was no exception.

During the 1970s, the US oil market had been regulated by the government, but government intervention tended to exacerbate the market conditions that it was expected to resolve. President Richard Nixon's price controls, which began in August 1971, exacerbated the tight market situation by creating shortages of different products at

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[109] Fesharaki and Razavi, "Spot Oil, Netbacks and Petroleum Futures," 2.

[110] David Harvey, *A Brief History of Neoliberalism* (Oxford: Oxford University Press, 2005), 20-25.

different periods during the 1970s. Heating shortages during late 1972 and severe shortages of gasoline in 1973, triggered by oil companies cutting imports, were good examples. To solve all these problems, Congress passed the Emergency Petroleum Allocation Act (EPAA) in 1973, which created a two-tiered pricing system for domestic oil. According to the regulation, "old" domestic oil, designated as crude oil from properties producing at or below their 1972 production levels, was subject to a price ceiling, while "new" domestic oil was decontrolled and could be sold at market prices. Imported oil was not regulated. The increase in world oil prices caused mainly by the Arab oil embargo created a significant disparity between the costs of old and new oil and additional programs such as the Supplier-Purchaser Rule, the Buy-Sell Program, and the Crude Oil Entitlements Program, were introduced to solve these problems. However, all these efforts were fruitless, resulting not only in the slowdown of growth in domestic exploration and a drop in domestic production but also ultimately in an increase in oil imports. To encourage domestic production and exploration, the EPAA regulations were modified by new rules under the Energy Policy and Conservation Act (EPCA) of 1975. The major innovations of EPCA were the rollback of previously uncontrolled new oil prices under EPAA and the inclusion of new oil in the entitlements program. None of these measures brought any of the desired results, as they only gave mild incentives to oil companies to increase oil imports, as well as discouraging consumers from moving from oil to other alternative energy sources and from conserving oil consumption. During the 1970s, government regulations, particularly domestic price controls on oil and refined products, had very negative effects on both oil producers and consumers, resulting in a reduction in domestic production and an increase in oil consumption, while they helped

OPEC to dominate the world oil market.[111] Furthermore, the price controls were universally perceived by the more import-dependent counties as subsidizing intemperate US oil imports and making the US compete aggressively for oil supplies in the world oil market, which brought about rising oil prices and a tightening oil supply.[112]

A gradual shift toward a market-oriented US oil policy began in 1979.[113] On April 5, 1979, President Jimmy Carter announced the phasing out of fixed oil prices beginning on June 1, and continuing at a fairly uniform rate over the next 28 months with the eventual expiration of price control authority by October 1, 1981 to minimize any sudden inflationary shock. In his "Energy Address to the Nation," he pointed out that government price controls had resulted in holding back domestic production and encouraging extravagant oil consumption and increasing dependence on foreign oil. In particular, he had great concerns about the growing dependence of the US on OPEC oil, because this made it more vulnerable to sudden price rises and interruptions in supply imposed by OPEC. He strongly believed that removing controls would raise US crude

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[111] Peter Van Doren, "A Brief History of Energy Regulation," Cato Institute, http://www.downsizinggovernment.org/energy/regulations (accessed December 9, 2013); U.S. Energy Information Administration, "Petroleum Chronology of Events 1970-2000," U.S. Department of Energy, http://www.eia.gov/pub/oil_gas/petroleum/analysis_publications/chronology/petroleumchronology2000.htm (accessed December 9, 2013).

[112] Petroleum & Energy Intelligence Weekly, "Carter's Price Plans and Windfall Tax Draw Fire in U.S.," *Petroleum Intelligence Weekly* XVIII, no. 16 (April 16, 1979): 3.

[113] At the Bonn Summit held between July 16 and 17, 1978, President Carter promised to take steps to end controls over crude oil prices. However, the US government could not implement this plan in early 1979 because of the uncertainties caused by events in Iran. At a news conference in January, 1979, US Energy Secretary Schlesinger made clear that the administration would further postpone its long-deferred proposals for relaxing controls over domestic oil prices until the potential for supply shortages from the Iranian disruption was alleviated. See "U.S. Deferring Oil Price Decisions Due to Iran Cutoff," *Petroleum Intelligence Weekly* XVIII, no. 2 (January 8, 1979): 2.

prices to world levels and consequently encouraged both conservation and production in the US by removing rewards for those who imported foreign oil and by discouraging waste. At the same time he urged the Congress to enact a new "windfall profits" tax on oil companies to capture part of the huge unearned income that this action would generate.[114] During Jimmy Carter's last two years in office, decontrolling US crude prices was fairly straightforward. US domestic oil prices gradually moved up to free-market levels, while 16% of total domestic output reached to the freely priced "market tier" in July 1980 (up from only 2% in January 1980). Furthermore, over half of US oil output remained uncontrolled in July 1980, recording 57% of the total output from 50% in June 1980.[115] After a fierce debate on the windfall profits tax, Congress eventually agreed and Carter finally signed the Crude Oil Windfall Profit Tax Act (Public Law 96-223) into law on April 2, 1980, hoping that "through this fair tax we could divert the unearned profits of the American oil companies to our poor, to improving rapid transit, urban transit, to providing new energy sources, and to conservation of energy."[116] Given that the federal budget had been in deficit for a long time, it must have been really hard to refuse this new source of revenue. At that time, the government calculated that it would acquire approximately $700 million out of the total $1 trillion in windfall revenues generated

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[114] Jimmy Carter, "Energy Address to the Nation," April 5, 1979, online by Gerhard Peters and John T. Woolley, *The American Presidency Project*, http://www.presidency.ucsb.edu/ws/?pid=32159 (accessed January 4, 2014).

[115] Petroleum & Energy Intelligence Weekly, "What's New around the World: Over Half of U.S. Oil Output Now Decontrolled," *Petroleum Intelligence Weekly* XIX, no. 42 (October 20, 1980): 10.

[116] Jimmy Carter, "Crude Oil Windfall Profit Tax Act of 1980 Remarks on Signing H.R. 3919 into Law," April 2, 1980, online by Gerhard Peters and John T. Woolley, *The American Presidency Project*, http://www.presidency.ucsb.edu/ws/?pid=33214 (accessed December 14, 2013).

from higher oil prices during the 1980s.[117]

President Ronald Reagan accelerated the implementation of neoliberal economic policies in the domestic oil market. On January 28, 1981, he signed Executive Order 12287, which immediately eliminated all remaining federal controls on US oil production and marketing. He thought that this would remove the growing uncertainty and fears that the government would breach the planned deregulation.[118] However, it is highly possible that the real reason behind early deregulation was to secure greater tax revenues for the new administration. During his presidential campaign, he promised both a general tax cut and higher defense spending, which could not be achieved without securing new sources of revenue. By putting deregulation in force somewhat earlier, the Reagan administration could acquire about 85% of any increase in the price of previously price-controlled domestic oil through the windfall profits tax.[119] Henceforth, petroleum price and allocation deregulation would allow market forces to determine US refining policy. As a result, crude-short refiners could not depend on supplies allocated by the government even during tight market situations. Furthermore, the Reagan administration clarified that it would not use federal aid to rescue the small domestic refiners on the verge of

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[117] Petroleum & Energy Intelligence Weekly, "U.S Windfall Tax Bonanza Based on $75 Oil Price in 1990," *Petroleum Intelligence Weekly* XIX, no. 10 (March 10, 1980): 3.

[118] "Statement on Signing Executive Order 12287, Providing for the Decontrol of Crude Oil and Refined Petroleum Products January 28, 1981," *The Public Papers of President Ronald W. Reagan*, Ronald Reagan Presidential Library, http://www.reagan.utexas.edu/archives/speeches/1981/12881b.htm (accessed December 20, 2014).

[119] Petroleum & Energy Intelligence Weekly, "U.S. Price Decontrol Seen Imminent Under Reagan," *Petroleum Intelligence Weekly* XX, no. 4 (January 26, 1981): 1, 4.

bankruptcy after the end of special government programs. The administration expected that some of them would shut down "in the interests of a free market," and the US would lose some of its refining capacity to foreign refiners.[120] After the bitter experience of US interventionist oil polices during the 1970s, which did not bring any obvious benefit to domestic oil producers and made the US more vulnerable to OPEC's arbitrary oil policies, the Reagan administration decided to move toward a market-oriented oil policy as a long-term remedy for the reconstruction of both the domestic and world oil industry.

After the positive results of the deregulation of oil price and allocation, Reagan's confidence in the free market led him to introduce additional moves to reinvigorate market forces in the oil industry. In his remarks on the Program for Economic Recovery at a White House reception for members of Congress on September 29, 1981, he showed his satisfaction with the results of deregulation: a major spurt in exploration and increases in domestic production in the lower 48 states.[121] These satisfactory results encouraged him to push market-oriented oil policies more aggressively. In an effort to tie the US price closer to world markets, the Reagan administration lifted restrictive quotas on the export of all oil products in October 1981 with the expectation of an increase in residual fuel oil exports. Furthermore, the administration wanted to remove the ban on Alaskan oil

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[120] "Reagan Will Let Free Market Set U.S. Refining Policy," *Petroleum Intelligence Weekly* XX, no. 9 (March 12, 1981): 4-5.

[121] "Remarks on The Program for Economic Recovery at a White House Reception for Members of Congress September 29, 1981," *The Public Papers of President Ronald W. Reagan*, Ronald Reagan Presidential Library, http://www.reagan.utexas.edu/archives/speeches/1981/92981h.htm (accessed December 20, 2014).

in spite of congressional and oil industry opposition.[122] When the issue of exporting Alaskan oil to Japan began to be seriously discussed by the Reagan administration, Frank H. Murkowski, Senator for Alaska, sent William Clark, National Security Advisor, a letter on May 10, 1983, showing his support for oil exports and his willingness to assist on this issue.[123] However, the US Congress remained opposed to lifting the ban on sales of Alaskan crude to Japan because of its sensitivity both to strategic arguments and to US maritime interests. In addition, the Alaskan oil producers had already made long-term commitments to the Panama pipeline and had invested in additional US-flagged tankers for the eastern US market. With the increase in Alaskan oil production, shipments of Alaskan North Slope crude to eastern US refineries increased more than 200,000 b/d, or approximately 40%, recording 801,000 b/d in 1982 from 578,000 b/d in 1980. This increase effectively displaced foreign crude on the Gulf and East Coasts.[124]

In spite of the Reagan administration's efforts to export Alaskan oil to Japan, it failed to persuade Congress. At the very beginning, the Reagan administration had considered that US-flagged ships should deliver half of the Alaskan oil to Japan.[125]

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[122] Petroleum & Energy Intelligence Weekly, "U.S. Aiming to Lift Restrictions on Oil Product Exports," *Petroleum Intelligence Weekly* XX, no. 40 (October 5, 1981): 1-2; "What's New around the World: United States," *Petroleum Intelligence Weekly* XX, no. 41 (October 12, 1981): 8.

[123] Letter, Frank H. Murkowski to William Clark, May 10, 1983, folder "Oil (May 1983)," box 82, Executive Secretariat, NSC: Subject File, Ronald Reagan Library.

[124] Petroleum & Energy Intelligence Weekly, "U.S. Aiming," 2; "Alaskan Oil Exports Unlikely to Get OK from US Congress," *Petroleum Intelligence Weekly* XXII, no. 19 (May 9, 1983): 4-5.

[125] Memo, Richard Levine to John M. Poindexter, April 28, 1983, folder "Oil (July 1982-April 1983)," box 81, Executive Secretariat, NSC: Subject File, Ronald Reagan Library.

However, after facing strong oppositions from Congress, Frank Murkowski and Ted Stevens, the two senators from Alaska, urged Robert McFarlane, National Security Advisor, to support their amendment to the Export Administration Act (EAA) on February 2, 1984. This amendment would permit the export of 200,000 b/d on condition that any crude so exported be transported in US-built and documented vessels, and that such vessels should be American-operated and that they should be maintained in US shipyards.[126] The administration was willing to endorse this attempt, if the Senators would move expeditiously on this amendment.[127] However, the Reagan administration's efforts to apply free market principles to US crude oil exports could not in the end overcome determined opposition from Congress.

With the wave of neoliberal economic practices, market-oriented oil polices endorsed by the US government eventually helped to accelerate structural changes on the world oil market. During the second oil crisis, OPEC members raised their prices by applying illogical differentials, premiums and surcharges, as a result of skyrocketing spot market prices. At the same time, the US, which consumed one-fourth of world oil, allowed market forces to maneuver in the oil market in the hope of discouraging oil demand and of increasing domestic oil production rather than trying to control oil prices at relatively low levels. Continuing market-oriented oil policies during Reagan's presidency began to reward consumers with moderate oil prices, as can be seen from a

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[126] Letter, Ted Stevens and Frank H. Murkowski to Robert McFarlane, February 3, 1984, folder "Oil (November 1983-02/26/1984)," box 82, Executive Secretariat, NSC: Subject File, Ronald Reagan Library.

[127] Memo, Roger W. Robinson to Robert C. McFarlane, February 7, 1984, folder "Oil (November 1983-02/26/1984)," box 82, Executive Secretariat, NSC: Subject File, Ronald Reagan Library.

note for press guidance written for the President regarding OPEC and oil in February 1983.

> Certain reductions in crude oil prices have been announced by Norway, the United Kingdom and Nigeria. Others may follow. These reductions have come in response to decreased demand for petroleum products as a result of conservation measures and the worldwide recession, which is now ending—in other words, in response to market forces. Market-oriented actions taken by this Administration, such as decontrol of domestic oil prices, have contributed to the present situation of a more reasonable relationship between supply and demand and resulting moderation of prices. This will be good news for American consumers and producers alike.[128]

These structural changes in the world oil market promoted by greater reliance on market forces brought the expected results in a relatively short time, and contributed to the emergence of a new oil price regime, thus undermining OPEC's previously unrestricted power to control oil prices.

Market forces began to take over the global oil market with the growth of the spot market in the course of the 1980s. Downward spot price trends in early 1982 encouraged non-OPEC countries, particularly North Sea producers, to reduce their prices. The pressures to reduce OPEC's prices led it to adopt a production-rationing scheme to defend the official price of Marker Crude at $34 per barrel in March 1982. There were violent fluctuations on the spot markets for crude oil and refined products in 1982,

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[128] Memo, Norman A. Bailey to William P. Clark, February 22, 1983, folder "Oil (July 1982-April 1983)," box 81, Executive Secretariat, NSC: Subject File, Ronald Reagan Library. In the final press release, the sentence, "For years, crude prices have been kept high as a result of the activities of the Organization of Petroleum Exporting Countries and inappropriate policy responses on the part of some of the importing countries, including ours," was omitted, presumably because the US government did not want to irritate OPEC members unnecessarily. The omission of this sentence implicitly showed the strong willingness of the Reagan administration to implement market-oriented oil policy and not to repeat earlier mistakes, while it attributed unreasonably high oil prices in the past to OPEC and government-interventionist oil policies. However, as OPEC was still the dominant power in the world oil market at that time, the administration's attitude towards OPEC needed to be cautious.

reflecting some success for OPEC's polices. However, many OPEC members could not resist the temptation to sell their oil on the spot market to acquire more revenue, exceeding their own quotas in late 1982 and early 1983. Other downward spot price trends emerged and patterns familiar from 1982 were repeated. At this time, OPEC tried to resist the overwhelming pressures of market forces not only by restricting its production, but also by reducing its official marker price from $34 to $29 per barrel in March 1983. Spot prices in the period from March 1983 to May 1984 were relatively stable, staying around the official price. During this period, the oil market was recovering and non-OPEC producers took a cautious attitude towards OPEC by setting their oil prices at acceptable levels.[129] However, unrestricted increased production from both OPEC and non-OPEC countries would produce a glut on the oil market in the summer of 1984. OPEC members again failed to restrain themselves from selling as much of their oil as they could on the spot market. OPEC tried to overcome this harsh market situation by securing the cooperation of the non-OPEC producers, and this attempt seemed to achieve the desired results in a short time. However, the considerably increased influence of market forces over the global oil market finally led the non-OPEC countries to move toward market-oriented oil policies after late 1984. The spot market could no longer be ignored. In the world oil market during 1984-1985, 30-35% of oil was traded on the spot market in various ways compared with 5-10% in 1979.[130] Although OPEC members tried to maintain their price structure by cutting production ceilings and the

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[129] Petroleum & Energy Intelligence Weekly, "Big Ups and Downs in 1982 Spot Prices Obscure Flat Trend," *Petroleum Intelligence Weekly* XXI, no. 51-52 (December 20, 1982): 1-2; Fesharaki and Razavi, "Spot Oil, Netbacks and Petroleum Futures," 73-74.

[130] "Spot Oil, Netbacks and Petroleum Futures," 2.

official price, particularly after the non-OPEC countries entered the free market, OPEC alone could not defend its prices from the tidal waves of market forces. Increasingly manipulated by market forces, the global oil market had slipped out of OPEC’s control by 1985, and even challenged OPEC’s solidarity. As OPEC members cheated on their quotas by resorting to various spot-related deals such as barter deals and counter-financing deals, the organization gradually lost its raison d'être.

CHAPTER IX

SAUDI OIL POLICY IN THE 1980s SLUMP

Changes in Saudi oil policy toward an emphasis on the state's long-term economic interests were closely related to political developments in the Middle East after late 1979. The split in the Arab world caused by the Iran-Iraq War and the increasing threats from the Soviet Union in the region, especially in Afghanistan and Yemen, increased the maneuverability of Saudi oil policy. During this period, Saudi policy-makers did not hesitate to make use of the political climate to advance their economic and political interests. In the process, they made inconsistent and often exaggerated comments about their oil policy to maximize their bargaining power vis-à-vis both other OPEC members and the United States. Their behavior has misled many researchers and brought them to inaccurate conclusions about the essence of Saudi oil policy during this period. However, if we look more thoroughly into Saudi policy during the first half of the 1980s, we can reach the conclusion that it was intended to maximize the country's long-term economic interests. With increasing autonomy over oil policy because of the new political configuration in the Middle East, Saudi oil policy as a "swing producer" during this period was clearly established on the basis of its principal long-term economic interest, control of the world price of oil.

In contrast with the tight market in the 1970s, this oil policy in a slack market condition during the first half of the 1980s required the Saudi economy to bear a large and unnecessary sacrifice for more than three years. It is generally believed that Saudi Arabia's long-term economic (and also political) interests were based on moderate oil prices. However, it tried to defend relatively high oil prices by reducing its output considerably in this period. In this chapter, we will find out what factors made Saudi Arabia defend OPEC's relatively high oil prices for a long time and then suddenly give up this position in 1985. We will also see how it manipulated price collapses in 1985 and 1986, which unintentionally contributed to the rearrangement of the world oil market, and coped with this crisis.

New Political Configuration in the Middle East and Its Implication in Saudi Oil Policy

It became clear that Saudi oil policy was primarily based on its long-term economic interests in the early 1980s. Although Saudi Arabia expected some political rewards from the West, particularly the United States, by upping its production to almost maximum levels in this period, its oil policy could be clearly understood as an attempt to reunify OPEC's pricing system. To implement its oil policy based on its long-term economic interests, as explained in Chapter VII, it was necessary for Saudi Arabia to restore its position as a price setter in the world oil market through the manipulation of OPEC. In response to a letter of November 16, 1981 from Congressman Johan Paul Hammerschmidt complaining about oil price rises even after the Reagan administration's decision to sell an Air Defense Enhancement Package to Saudi Arabia including five E-3A AWACS aircraft, AIM-9L air-to-air missiles, and KC-135 air-to-air tankers, Powell A.

Moore, Assistant Secretary for Congressional Relations, clarified that the arms sales to Saudi Arabia were determined in the context of the long-standing security relationship between the two states for the defense of vital mutual interests, and were not based on any quid-pro-quo from Saudi oil policy makers. In addition, he stated that Saudi oil policy was determined primarily by economic considerations based on the country's best national interests. In his explanation to Mr. Hammerschmidt, a $2 rise in the price of Arabian Light as the "Marker Crude" at the OPEC Conference in October 1981was part of Saudi Arabia's compromise with other OPEC members, which resulted in much larger price reductions on the part of most other OPEC producers and a commitment to freeze prices in 1982. Moore saw Saudi oil policy based on economic considerations as a healthy development and hoped that its reversal would not be encouraged.[1] The Reagan administration was well aware that Saudi oil policy in this period was constructed on the basis of the country's economic interests and this understanding led the US government to continue its policy of encouraging market forces in the world oil market, making the United States less concerned with any possible retaliation on the part of Saudi Arabia.

Because of the changing political environment in the Middle East since the end of 1979, Saudi Arabia's oil policy autonomy had greatly increased and political developments on the regional level allowed the government to implement an oil policy based on its own long-term economic interests without any serious challenges from neighboring countries during the early 1980s. Although politically motivated, Saudi oil policy in the first half of 1979 severely challenged the state's long-term economic interests by undermining Saudi Arabia's position as a price setter on the global oil market.

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[1] Letter, Powell A. Moore to John Paul Hammerschmidt, June 18, 1982, Department of State.

It had few policy options mainly because of a heightened political urgency at the regional level. However, political events in the Middle East in late 1979 and the early 1980s made it possible for the government to reorient its oil policy toward economic considerations by increasing its oil policy autonomy. With the deterioration of relations between Iraq and Syria in late 1979, Syria's revival of the Steadfastness Front (compromising of Syria, Libya, Algeria, PDRY, and the PLO) provided the Saudis with greater room for maneuver between Iraq and Syria to relieve the political pressures against them from both countries.[2] Furthermore, the confrontation between the US and revolutionary regime in Iran initiated by the Iranian militants' seizure of the American Embassy in Tehran and the detention of hostages on November 4, 1979 certainly created a favorable political environment for the Saudis from three perspectives. First, according to Safran, it automatically provided the Saudis with increasing security for the oil transit routes and their oil facilities because of the dispatch of a US carrier task force to the Gulf area to deter the militants from harming the hostages. Second, the increasing attention of the revolutionaries to the confrontation with the US and the sanctions against Iran considerably weakened Iran's capacity for local mischief making. Finally, the confrontation encouraged Iraq and the US to come closer together because of their common hostility to Iran, which permitted the Iraqi government to tolerate Saudi Arabia's security relationship with the United States.[3] Two other events, the Soviet invasion of Afghanistan in late December 1979 and the Iran-Iraq War in September 1980, further increased the maneuverability of the Saudi regime in its foreign and oil policies.

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[2] Safran, *Saudi Arabia*, 316.

[3] Ibid., 358.

Although these two events exposed the Saudis to severe security problems in the Gulf, they also deepened the profound split between Damascus and Baghdad, not only weakening Syria's political influence in the Middle East arena, but also easing collective political pressures against Saudi Arabia from its Arab neighbors.[4]

During this period, Saudi Arabia was relatively free of interference from its three major neighbors, Iran, Iraq and Syria, in implementing its oil policy. Relations between Saudi Arabia and Iraq became closer and more cooperative, and Iraq became relatively tolerant of the close relations between Saudi Arabia and the United States. On the other hand, Iran, a hard-liner within OPEC, had limited influence over other OPEC members, because its political leadership was considerably distracted by the confrontation with the United States and the war with Iraq, which rapidly developed into a stalemate. Particularly after the fall of Bani Sadr in June 1981, Iran became paralyzed by political struggles among extremist factions. In the case of Syria, its denunciation of the close relations between Saudi Arabia and the United States had little effect on Middle East politics, because of Syria's close military ties with the Soviet Union, which had invaded a Muslim country, Afghanistan on December 27, 1979. Furthermore, Syria was in a dangerous position in Lebanon, as its relations with Israel were such that there was a real danger of an Israeli-Syrian war in the spring of 1981. During the summer of 1981, Saudi Arabia's diplomatic efforts played an important role to help Syria out of the entanglement with Phalangist militias around Zahle.[5] In this situation, Saudi Arabia's policy of raising its oil production to almost maximum levels was not seriously challenged by most of its

[4] Ibid., 318.

[5] Ibid., 329-32, 75-76.

neighbors during the early 1980s.

Given the degree of political turmoil in the Middle East in this period, Saudi Arabia desperately needed military cooperation from the United States, but it could not agree to any overt or direct cooperation with US forces. In response to the increasing political instability in the Gulf caused by the Soviet invasion of Afghanistan, President Carter announced in his State of the Union address on January 23, 1980, known as the Carter Doctrine, that "an attempt by outside forces to gain control of the Persian Gulf region will be regarded as an assault on the vital interests of the United States, and such an assault will be repelled by any means necessary including military force."[6] When National Security Council Advisor Zbigniew Brzezinski and Deputy Secretary of State Warren Christopher visited Riyadh on February 4-6, 1980 to discuss the regional security situation and possible military cooperation with Crown Prince Fahd and Foreign Minister Sa'ud, they could not reach an agreement on President Carter's call for a "Middle East security framework with the Egyptians, the Saudis, the Pakistanis and the Turks." Instead, the Saudi rulers requested F-15 enhancements and five E-3A AWACS aircraft.[7] During this critical period, it became clear to Saudi Arabia that a new airborne warning and control system could effectively protect its oil facilities and widely scattered key population centers from any attacks on all borders including the most vulnerable on its Gulf Coast. Shortly after the fall of the Shah, the Saudi Air Force (SAF) and the United States Air Force (USAF) had already begun a joint feasibility study for the modernization

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[6] Jimmy Carter, "The State of the Union Address Delivered before a Joint Session of the Congress," January 23, 1980, online by Gerhard Peters and John T. Woolley, *The American Presidency Project*, http://www.presidency.ucsb.edu/ws/?pid=33079 (accessed June 24, 2014).

[7] Long, *The United States and Saudi Arabia*, 63-64; Safran, *Saudi Arabia*, 407.

of the Saudi Air Force, which resulted in a detailed plan in December 1980. According to the "Air Feasibility Study" of July 1980, 5 E-3A aircraft were sufficient for the SAF to cover the entire Gulf coast.[8]

Political considerations in the domestic and regional arena prevented the Saudi regime from reaching an agreement on a regional strategic alignment, a so-called "strategic consensus," with the United States, which enthusiastically sought bases and facilities in the Gulf region for the development of its Rapid Deployment Force (RDF). The seizure of the Grand Mosque in Mecca on November 20, 1979 and the Shi'i uprising in the Eastern province in the same month revealed the regime's endemic instability, and undermined its credentials as the protector of two Muslim holy cities. In particular, the demands of the Mecca insurgents primarily criticized the connections between the Saudi family and the United States, the wastage of the country's oil wealth, and the corruption of its rulers.[9] In this atmosphere of chaos, it was difficult for the Saudi regime to be seen to be participating in any open military cooperation with the United States. On the other hand, the hostile reactions to the Carter Doctrine on the part of Saudi Arabia's radical Arab neighbors, particularly Iraq and Syria, as well as Iran, made the regime hesitant to participate in a US-promoted "strategic consensus." Syria, Iran and Iraq had already denounced the Carter Doctrine for their own political reasons. Assad viewed Carter's statement as an attempt by the US to profit from the situation in Afghanistan to promote its own anti-Soviet and hegemonic designs in the region. On January 26, 1980, he flew to Riyadh to try to persuade Crown Prince Fahd not to join the American "alliance."

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[8] Anthony H. Cordesman, *Western Strategic Interests in Saudi Arabia* (London: Croom Helm, 1987).

[9] Middle East Research and Information Project, "Saudi Opposition Group," 16.

Although Saudi Arabia condemned the Soviet invasion of Afghanistan at the Islamic Conference in Islamabad on January 26- 29, 1980, thus undermining Syria's position and widening the gap between Baghdad and Moscow, it also tried to pacify Assad by making clear its opposition to Camp David. Given the state of relations between Syria and Saudi Arabia, overt military cooperation with the United States would have posed an unnecessary provocation to Syria, the leader of the Steadfastness Front. As Iran also regarded the possible installation of the American military facilities in the region as a direct threat, any declaration of Saudi support for the Carter Doctrine would have been an unnecessary provocation to Iran as well. On the other hand, Iraq wanted to capitalize on the vulnerability of the smaller Gulf states caused by the political events on the regional level to gather them under its own umbrella in the name of Pan-Arabism. Saddam Husayn issued his Charter for Pan-Arab Action on February 8, 1980, which called for nonalignment and for inter-Arab solidarity against any foreign aggression and the rejection of any foreign military presence on Arab territory. Since the Saudis wanted to maintain close relations with Iraq against Iran, they were prepared to endorse Husayn's Charter.[10] Partly because of political pressures from Syria, Iraq and Iran, Saudi Arabia felt obliged to pull away from participating in the US- led "strategic consensus."

Since 1980, Saudi Arabia had made serious efforts to form the GCC, which would involve close defense and security cooperation with five smaller Gulf states. It was clear that the Saudis hoped to enhance their own military security by promoting the GCC instead of participating in any US-led regional security scheme. With the outbreak of the Iran-Iraq War, Saudi Arabia accelerated the establishment of the GCC. During the war,

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[10] Safran, *Saudi Arabia*, 319-20, 59-60, 407.

the five smaller Gulf states, which supported Iraq, became more vulnerable to military threats from Iran, which carried out air strikes against Kuwait as early as November 1980. Soon after these attacks, the Saudi Interior Minister, Prince Nayif, declared that Saudi Arabia would sign bilateral security agreements with all the Gulf states as a first step toward a unified Gulf security arrangement, although Kuwait refused to sign. Because of strong opposition from Iran and Iraq, Saudi Arabia shelved the idea for a while. However, within a year, Saudi Arabia had successfully signed bilateral security agreements, first with Bahrain and then with the UAE, Qatar and Oman. At a meeting in Riyadh on February 4, 1981, the foreign ministers of the Gulf countries endorsed a Saudi proposal to set up the GCC. At that time, Saudi officials insisted that the GCC was not intended either as a military or a political bloc. A communiqué at the end of the first GCC summit on May 25-26, 1981 did not mention anything about defense and security cooperation among member countries so as not to provoke or antagonize Iran and Iraq. However, there was no doubt that the primary function of the GCC was for the collective defense and security of its members given the current political turmoil in the Middle East.[11]

In the process of the formation and development of the GCC, the conflicting political interests of the member countries, particularly Kuwait, also prevented the Saudi regime from having direct military cooperation with the United States. Kuwait, which was adjacent to the two regional rivals, Iran and Iraq, was the most crucial member of the GCC because of its geopolitical importance in the Gulf. Because of its political vulnerability to Iran and Iraq, Kuwait might have been expected to be a strong advocate

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[11] Johnson, *The Iran-Iraq War*, 94; Matteo Legrenzi, *The GCC and the International Relations of the Gulf: Diplomacy, Security and Economic Coordination in a Changing Middle East* (London: I. B. Tauris, 2011), 80; Safran, *Saudi Arabia*, 373-74.

of regional cooperation with the other Gulf states that had shared similar political, cultural and economic interests since the late 1970s. Considering its role and importance in the GCC, the Saudi foreign minister pointed to his Kuwaiti counterpart before the press at the meeting of the Gulf foreign ministers in Kuwait on February 5, 1981, and spoke highly of him, "Here is the father of the [GCC] project."[12] However, while Oman wanted to invite American troops to defend the region, and finally concluded a defense treaty with the United Sates that permitted US troops to be stationed in Oman in any emergency, Kuwait took a neutral stance toward the superpowers. It favored an entirely Arab-based joint military command for external security and maintained diplomatic relations with the Soviet Union until September 1985.[13] Furthermore, soon after the announcement of Saddam Husayn's Charter on February 1980, most of the smaller Gulf countries, Qatar, Bahrain and Kuwait, expressed their support while Oman did not. This reaction from the smaller Gulf countries made it more difficult for Saudi Arabia to join the US-sponsored regional security scheme for the successful establishment of the GCC. The Gulf countries' ambivalent relations with the United States resulted in a communiqué in May 1981 to affirm the GCC's "absolute rejection of foreign interference in the region from any source" in an effort to allay apprehensions about a possible link between the GCC and the US-led Gulf security strategy.[14]

Even after the formation of the GCC, Kuwait remained reluctant to sign any

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[12] Emile A. Nakhleh, *The Gulf Cooperation Council: Policies, Problems and Prospects* (New York: Praeger, 1986), 2.

[13] Johnson, *The Iran-Iraq War*, 95; Nakhleh, *The Gulf Cooperation Council*, 40-41.

[14] Safran, *Saudi Arabia*, 361, 74.

defense and security agreement with Saudi Arabia. When Saudi Arabia pushed for Saudi-led bilateral security agreements with the GCC states in late 1981 and early 1982 after the discovery of an Iranian-instigated plot to overthrow the government of Bahrain in December 1981, most of the smaller Gulf countries signed bilateral security agreements with Saudi Arabia. However, Kuwait refused to do so, let alone accede to a multilateral regime suggested by the Saudi Interior Minister, Prince Nayif, because it was afraid of a possible collision with the Iranian regime.[15] By late 1981, the Iraqi offensive against Iran had lost its momentum, and in September the Iranians had driven the Iraqis out of Abadan. Saddam Husayn suggested a one-month cease-fire to Iran during Ramadan, but the Iranians did not accept. In late November the Iranians launched another successful offensive against the Iraqis in Bostan, occupying it after a weeklong battle. This defeat resulted in the cutting of communications and logistical links with the Iraqi forces at Dizful and Ahwaz. At the same time, Iranian aircraft attacked a Kuwaiti refinery at Umm Aayash on October 1, 1981.[16] All these developments discouraged Kuwait from signing any bilateral or multilateral security agreement with Saudi Arabia.

Saudi Arabia's main priority in this period was to purchase sophisticated weapons from the United States, both to enhance its own national security and to implement its strong leadership within the GCC. According to Safran, Saudi Arabia and Iraq had apparently been competing with each other to put their smaller Gulf neighbors

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[15] After the dissolution of the Kuwaiti parliament in 1986, the Supreme Council ratified a multilateral agreement in December 1987. See Legrenzi, *The GCC and the International Relations*, 80-81; Nakhleh, *The Gulf Cooperation Council*, 46.

[16] Johnson, *The Iran-Iraq War*, 94; Safran, *Saudi Arabia*, 377-79; Marion Farouk-Sluglett and Peter Sluglett, *Iraq since 1958: From Revolution to Dictatorship* (London: I.B. Tauris, 2003), 259.

under their own defense and security umbrellas since 1979. The Saudi leaders had to build up advanced military capacity to prevent their Gulf neighbors from slipping under the influence of Iraq in the face of the threats from Iran. Furthermore, the Saudi leaders, who had been prepared for the war between Iran and Iraq and had secretly agreed on Iraq's limited war strategy during Saddam's visit to Riyadh on August 6, 1980, felt that the rapid improvement of their own military capacity would enable them to deal with the new strategic configuration in the Middle East that would emerge in the wake of Iraq's expected victory. In this regard, they enthusiastically approached the US to approve their request for arms, particularly F-15 enhancement equipment and AWACS aircraft.[17]

Saudi Arabia made use of its oil policy in order to purchase advanced American weapons. As we have seen, Saudi oil production reached almost maximum levels in 1979 and the early 1980s. Although Saudi oil policy was based on the state's long-term economic interests, Saudi officials argued that they were producing more oil than they needed in order to create a healthy Western economy. This kind of lip service was clearly designed to gain political rewards, including arms purchases, from the West, particularly from the United States. Saudi officials were evidently disappointed with the Carter administration's decision to reject Saudi Arabia's request for bomb racks and wing fuel tanks for F-15s in October 1980. In an interview with the *NYT*, Yamani said, "We've gotten no sign of appreciation for everything we've done." He emphasized that Saudi Arabia's own development needs required oil production at only half the current production rate of 10.3 million b/d. Mohammed Abdu Yamani, the Saudi Information Minister, also said, "We believe we are entitled to buy whatever we need as long as it

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[17] Safran, *Saudi Arabia*, 356-57, 62.

corresponds to United States policies."[18] They tried to put political pressure on the incoming Reagan administration for the purchase of advanced military items including AWACS, which gave the impression that their oil policy was designed to reflect the interests of the West rather than their own.

After the Carter administration turned down Saudi Arabia's request for arms, Saudi Arabia tried to maximize its bargaining power vis-à-vis the United States by reintroducing the possibility of using the oil weapon. In an interview with the Zurich weekly *Weltwoche* in December 1980, Yamani warned that "unless the Arab-Israeli conflict is solved the flow of oil from our countries will shrink suddenly and drastically," and that "we will deal that blow to you."[19] On January 29, 1981, Yamani delivered a more chilling and strong message to the new administration: "The Saudis are prepared to use their massive oil reserves as a weapon in a new Islamic *jihad*, or holy war, to recover Arab lands captured by Israel." He added, "We have never stopped using our oil as a political weapon."[20] Although Yamani related the Arab-Israeli conflict to Saudi oil policy, his main purpose was to support Saudi Arabia's wish to purchase sophisticated weapons from the United States. As mentioned in Chapter VII, Saudi Arabia had refrained from using the oil weapon to solve the Arab-Israeli conflict since June 1979. Even at the 10th Arab Summit Conference in Tunis on November 20-22, 1979, when the Arab-Israeli

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[18] Steven Rattner, "Arms Plea to Test Reagan, Saudis Say: Officials in Riyadh are Angry over Carter's Refusal to Sell Items to Upgrade F-15 Planes," *New York Times* December 19, 1980, A7.

[19] Middle East Petroleum and Economic Publications, "Saudi Arabia: Yamani Stresses Arab-Isreali Conflict as Threat to Oil Supplies," *Middle East Economic Survey* XXIV, no. 10 (December 22, 1980): 6.

[20] David Ignatius, "Confident Saudis Rattle Oil Weapon," *The Wall Street Journal* January 30, 1981, 25.

conflict was made a major priority in Middle Eastern politics, Saudi Arabia dexterously deflected Syria's request to use the oil weapon against the United States by using its strategic cooperation with Iraq.[21] As Safran remarked, "The Saudis' demonstrations of their independence from the United States were, paradoxically, also designed to prepare the ground among the Arab constituency for renewing and pressing their request for American arms, including AWACS aircraft."[22] Presumably Saudi officials considered that this gesture toward the United States would not only increase their bargaining power over arms purchases, but also nullify criticism from their Arab neighbors over relations between Saudi Arabia and America by raising Saudi Arabia's own voice regarding a fresh solution for the Arab-Israeli conflict.

The Saudi leaders' threats had some resonance among US officials. Soon after Yamani's interview with the *NYT* in December 1980, which showed his great disappointment with the Carter administration's rejection of the request for arms, the American ambassador to Saudi Arabia, John C. West, announced his thoughts on Saudi oil policy. He accepted Yamani's argument that Saudis were producing double the amount of oil they needed for their national economy. He asserted, "If they cut their production to 4.5 million barrels a day they could generate all the money they need for their five-year plan." Mr. West also warned that if the Reagan administration's relations

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[21] Safran, *Saudi Arabia*, 316-18.

[22] Ibid., 414; Fahd's peace plan of 1981 should be understood in this context. In Safran's opinion, "It is almost certain that when Fahd advanced his proposal his aim was to achieve some immediate tactical ends rather than to enunciate a major Saudi foreign policy program. One of those ends was to advance the prospects of the huge AWACS and F-15 equipment deal." See ibid., 332.

with Riyadh "deteriorate," the consequence would be to lower Saudi oil production.[23]

On the other hand, Saudi Arabia continuously presented the United States with an amicable oil policy in its efforts to achieve its military procurement goals. Particularly after the Iran-Iraq War, Saudi Arabia was producing more than 10 million b/d to stabilize the world oil market. In a major American interview on April 19, 1981, Yamani clarified the Saudi government's position regarding its oil price and production policy. He asserted that his government did not intend to budge from its high production strategy and would maintain its marker price at the $32/barrel level unless other OPEC members agreed to a price reunification at reasonable level. In terms of market situation at that time, he said, "This glut was anticipated by Saudi Arabia and almost done by Saudi Arabia," and additionally declared, "We engineered the glut, and we want to see it in order to stabilize the price of oil." Although he declined to link the sale of weapons to oil prices or oil production, all these gestures were evidently intended to elicit favorable responses from the United States. In his article in the *New York Times*, Steven Rattner pointed out, "Both Sheik Yamani's appearance – his first on a major American TV interview show in six years – and his unusually firm stand on pricing appeared timed to coincide with a debate in this country over whether to sell Saudi Arabia additional sophisticated weaponry."[24] In addition, Saudi officials tried to impress the United States as Saudi Arabia made an effort to avoid any disruptions in the flow of oil from the Persian Gulf resulting from the year-old Iran-Iraq War. The inauguration of a major oil pipeline, known as the East-West

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[23] Douglas J. Feith, "Saudi Production Cutback: An Empty Threat?" *The Wall Street Journal* March 30, 1981, 22.

[24] Steven Rattner, "Saudi Official Vows High Output of Oil until Prices Drop: Clash Set with Rest of OPEC," *New York Times* April 20, 1981, A1.

pipeline, in July 1981, showed that the Saudis had let Iraq build its own pipeline to the Red Sea across the Saudi desert in September. On October 12, 1981, Petroleum Information International, a Houston-based oil newsletter, said that Saudi Arabia was planning to build a 1.5 million barrel oil storage facility within 25 miles of the Red Sea port of Yanbu‘ to ensure against disruptions in its oil fields and pumping facilities along the Gulf coast. This bomb-proof strategic petroleum storage would be the world’s largest, almost twice the size of the US strategic petroleum reserve’s planned capacity of 750 million barrels of oil.[25] The timing of the news was particularly sensitive, because it came only two weeks after the Iranian air attack on a Kuwait oil refinery and just before the vote on arms sales to Saudi Arabia in both houses of Congress.

At the same time, Saudi officials were capitalizing on the political crises in the Middle East (made more acute by the increasing influence of the Soviet Union) in order to secure their military demands. At the National Press Club in Canberra, after the OPEC ministerial conference in Bali on December 15-16, 1980, Yamani warned against Soviet expansionism in the Middle East and urged the West to strengthen its allies in the Middle East as a bulwark against the Soviet Union. He rejected the US’ suggestion to deploy operational forces in the Gulf, because this might accelerate the Soviet Union’s aggressive military involvement, [26] but implicitly justified Saudi Arabia’s request for the purchase of American arms as the only effective option for defending the Gulf from the increasing threats of communism. Furthermore, Prince Fahd implicitly opened the

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[25] Youssef M. Ibrahim, "Saudi Arabia to Store Oil Near Red Sea to Avoid Vulnerable Persian Gulf Area," *The Wall Street Journal,* October 13, 1981, 2.

[26] Middle East Petroleum and Economic Publications, "Saudi Arabia: Yamani Fearful of New Oil Crisis and Soviet Designs on the Gulf," *Middle East Economic Survey* XXIV, no. 11 (December 29, 1980): 7.

possibility of cooperation with the Reagan administration against the threats from the Soviet Union on condition that the United States would provide Saudi Arabia with some political rewards, including arms sales of course.[27] On the eve of Reagan's inauguration as president, Prince Fahd urged him to show his good will towards Saudi Arabia and other Islamic nations. In an interview with the Saudi daily *'Ukaz*, published on January 19, 1981, Fahd affirmed that "if the new US administration shows real good will towards our causes, it will receive our full cooperation and be assured of our willingness to go with it all the way." In another interview, published in the Saudi daily *al-Riyadh* on January 18, he expressed his hope that the forthcoming Islamic Summit, to be held in Mecca on January 25, would reach full agreement and coordination with Islamic countries for a joint Islamic strategy for *jihad*. He also discussed the problem of security in the Gulf region, pointing out that "the security of the Gulf is a matter that concerns the states of the Gulf first and foremost, who are best qualified to preserve and protect this security; the danger to the area stems from international conflict and the rivalry of the superpowers."[28] Although Fahd did not directly request arms sales from the United States because of the sensitivity of the issue in the broader field of Middle Eastern politics, his statements definitely implied that sales of US military equipment to Saudi Arabia would be highly beneficial.

The Reagan administration, alarmed by Saudi Arabia's relatively tolerant attitude towards the Soviet Union, even including possible arms purchases, now began to

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[27] The Saudi government gave financial and military support to the *mujahidin* in Afghanistan in cooperation with the US against the USSR during the 1980s.

[28] Middle East Petroleum and Economic Publications, "Saudi Arabia: Fahd Urges Reagan to Demonstrate His Good Will to Saudi Arabia and Islamic World," *Middle East Economic Survey* XXIV, no. 15 (January 20, 1981): 6-7.

consider selling sophisticated arms to Saudi Arabia to encourage it to participate in a "strategic consensus." On December 1980, Saudi Arabia took a somewhat favorable position regarding the proposal of Leonid Brezhnev, the General Secretary of the Central Committee of the Communist Party of the Soviet Union, for the neutralization of the Persian Gulf.[29] Furthermore, Reagan's avowed strategy to strengthen the American military presence in the Middle East was countered by the Mecca Declaration's expression of "profound anxiety at increasing big-power rivalry for influence and efforts to increase military presence in the Arab areas and zones adjacent to Islamic states, such as the Indian Ocean, the Red Sea, the Arabian Sea and the Gulf. The peace and stability of the Gulf and its maritime routes are entirely the responsibility of the Gulf States, without foreign intervention of any kind" at the third Islamic Summit Conference on January 25-28, 1981.[30] More strikingly, in an interview with a group of Swedish journalists who accompanied King Carl Gustaf of Sweden on his tour of Saudi Arabia, published by the Saudi News Agency on February 23, Fahd stated that Saudi Arabia would not hesitate to purchase arms from the Soviet Union if it found "the doors of America and the West closed against us." At the same time, he condemned the campaign being waged by eight US senators against the supply of US arms to Saudi Arabia.[31] By distancing itself from the "strategic consensus" and raising the possibility that it would diversify its arms purchases, even including making approaches to the Soviet Union, the

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[29] Safran, *Saudi Arabia*, 414.

[30] Middle East Petroleum and Economic Publications, "Third Islamic Summit Consolidates Emergence of Islamic Bloc," *Middle East Economic Survey* XXIV, no. 16 (February 2, 1981): 4.

[31] "Prince Fahd Says Saudi Arabia Will Buy Arms from Soviet Union if Necessary," *Middle East Economic Survey* XXIV, no. 20 (March 2, 1981): i-iii.

Saudi government seems to have convinced the Reagan administration of the necessity of taking steps in its favor. On March 6, the administration announced that it had decided in principle to sell addition military equipment to Saudi Arabia, including five AWACS aircraft. Explaining its decision, the State Department said, “the critical fact today is that circumstances in the region have changed dramatically. The Soviet invasion of Afghanistan, the turmoil of the Iranian revolution, the Iran-Iraq War and the Soviet presence in South Yemen and Ethiopia underscore the instability in the region and the dangers of Soviet penetration and exploitation.”[32] The increasing instability in the region not only exposed the Saudi regime to external threats, but also gave it an excellent opportunity to strengthen its military capacity.

After the US decided to sell arms to Saudi Arabia in March, the efforts of the administration to attract the Saudis to the US-sponsored strategic consensus culminated in two official US visits to Riyadh in April 1981. However, both Secretary of State Alexander Haig’s Middle East tour on April 4-8 and the visit of a nine-man delegation of senators led by Senate Majority Leader Howard Baker to the region on April 12-17, seeking the adoption of an agreement on a “strategic consensus” by creating a regionally-based RDF, failed to persuade the Saudis. The Saudi Foreign Minister Prince, Sa‘ud al-Faisal, even expressed the hope that his colleagues had persuaded Mr. Haig to give up the idea of setting up bases in the region, adding: “We have the impression that he was also of the view that the presence of foreign troops is not necessarily the best way of dealing

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[32] Bernard Gwertzman, "U.S. Decides to Sell Equipment to Saudis to Bolster F-15 Jets," *New York Times* March 7, 1981, 1.

with areas of tension."[33] Furthermore, the endorsement by Kuwait, one of major members of the GCC, of a major Soviet declaration on Middle East policy on Aril 25, which included the exclusion of foreign military bases in the Gulf and the rejection of the Camp David process, combined with pro-Arab statements from Bonn and Paris on the Palestinian issue[34] considerably complicated the US' freedom to maneuver. As Saudi Arabia was already envisaging the enhancement of its defensive and security capability through the GCC without involving the superpowers, the United States had few options other than to accommodate its policies in the Middle East to Saudi Arabia's needs.

In early 1981, Saudi Arabia's efforts to establish the GCC were going smoothly, because it could capitalize on political events in the region. The Iran-Iraq War in particular provided Saudi Arabia with a golden opportunity to promote the establishment of the GCC. According to Legrenzi, "The Iran-Iraq War thus provided a perfect excuse for excluding Iraq from membership in the GCC. The war gave the six Gulf shaikhdoms the possibility of setting up an alliance that professed neutrality. The inclusion of Iraq would have led to a widening of the conflict, the rulers of the six states said, and this was to be avoided at the cost of excluding Iraq from the new organization."[35] At the Summit of the Organization of the Islamic Conference in January 1981, the leaders of the Gulf states informally exchanged their opinions on the future shape of the organization. The first meeting of the foreign ministers of the six countries was held in Kuwait on February

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[33] Jim Muir, "The Middle East Situation," *Middle East Economic Survey* XXIV, no. 27 (April 20, 1981): 9.

[34] "The Middle East Situation," *Middle East Economic Survey* XXIV, no. 28 (April 27, 1981): 13; "The Middle East Situation," *Middle East Economic Survey* XXIV, no. 30 (May 11, 1981): 10-11.

[35] Legrenzi, *The GCC and The International Relations*, 28.

4, 1981 to pave the way for the establishment of the GCC. There were two additional meetings of the six Gulf countries, first in Riyadh on February 24, and then in Muscat on March 4. The foreign ministers met again in Muscat on March 9 to approve the basic structure of the organization and the draft charter. The first summit was held on May 25-26, 1981 at which the six states formally declared the establishment of the GCC.[36]

In this critical period, when the Gulf states tried to strengthen their own military capacity under conditions of deteriorating security in the region, the Western countries competed with each other to provide the Gulf states with advanced weaponry to satisfy their defensive and security needs, and generally agreed on their policies towards the Arab-Israeli conflict to win their favor. On April 21, 1981, British Prime Minister Margaret Thatcher, accompanied by the Defense Ministry's top arms salesman, visited Saudi Arabia as part of her Middle East tour (April 19-25). On the same day, the Reagan administration officially confirmed that it had decided to sell sophisticated weaponry to Saudi Arabia in an attempt to assure the Gulf states of American reliability.[37] When other countries such as Britain, France and West Germany were aggressively rushing to the Gulf states to sell military equipment in the name of enhancing regional security,[38] the US administration also assumed its regional responsibilities by deciding to permit arms sales to Saudi Arabia, which would also bring huge financial benefits to the US as a part

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[36] Ibid., 31-33.

[37] Muir, "Middle East Situation (April 27, 1981)," 14.

[38] West German Chancellor Helmut Schmidt's visit to Saudi Arabia and the UAE was also scheduled on April 27-29, in which the sales of German Leopard-2 tanks would be discussed. A similar visit to Riyadh by the Austrian Chancellor, Bruno Kreisky was also planned on May 5-7. See "The Middle East Situation," *Middle East Economic Survey* XXIV, no. 29 (May 4, 1981): 14; "Middle East Situation (May 11, 1981)," 11.

of its petrodollar recycling scheme. Furthermore, favorable voices from West Germany and France regarding the Palestinian issue, which provoked Israel,[39] eventually led the Reagan administration to make strenuous efforts to gain Congressional approval for arms sales to Saudi Arabia.

The shrewd maneuvering of the Saudi regime during the political turmoil in the Middle East finally convinced the US to approve the arms sales. In spite of strong opposition from Congress, the Reagan administration successfully persuaded the senators to approve arms sales to Saudi Arabia. However, the House turned down the $8.5 billion transaction of arms sales to Saudi Arabia in a 301-111 vote against the White House on October 14, 1981.[40] On the following day, the Senate Foreign Relations Committee voted 9 to 8 to recommend rejecting Reagan's proposal to sell five AWACS aircrafts and other air-combat equipment to Saudi Arabia.[41] However, President Reagan's personal efforts to persuade the senators to approve these sales resulted in an important legislative victory. On October 28, the Senate finally voted 52 to 48 to approve the sales of AWACS planes and other air combat equipment to Saudi Arabia.[42] The Saudi Defense Minister, Sultan ibn 'Abd al-Aziz, expressed his deep gratitude for the Senate's vote in Saudi Arabia's favor and celebrated the victory, saying "the vote on the sale of the radar planes,

[39] "Middle East Situation (April 27, 1981)," 13; "Middle East Situation (May 11, 1981)," 10-11.

[40] Albert R. Hunt, "House Rejects Sale of AWACS to Saudi Arabia: Vote is 301 to 111, with GOP members Voting 108 to 78 against Reagan Proposal," *New York Times,* October 15, 1981, 2.

[41] Charles Mohr, "Senate Unit Votes, 9 to 8, to Oppose Saudi AWACS Sale," ibid., October 16, 1981, A1.

[42] "Senate, 52-48, Supports Reagan on AWACS Jet Sale to Saudis; Heavy Lobbying Tips Key Votes," *New York Times,* October 29, 1981, A1.

along with equipment that would enhance the performance of the F-15's that the Saudis are buying from the United States, was a victory for the policy of wisdom, moderation and reason followed by Saudi Arabia."[43]

Although the Saudis actively made use of their oil policy to secure the arms deal with the United States, the favorable decision of the Reagan administration was probably not a direct outcome of Saudi oil policy, since it was clearly in the political interest of the United States. It was at least possible that the failure of an arms sales deal with Saudi Arabia would have encouraged the regime to make overtures to the Soviet Union, coordinating the Fahd initiative with President Brezhnev's proposal in the Indian Parliament on December 10, 1980, which would have essentially neutralized the Persian Gulf, isolating it from the influence of the United States in particular. In addition, as the radical Arab and Palestinian hardliners and the Syrian and Iraqi regimes were worried about the AWACS affair, the deal gave Washington some leverage over the Saudis to induce them to ease Egypt's isolation in Arab politics, and thus remove some of the Arab hostility to Camp David.[44]

Given the political exigencies, and the threats to the security of the Saudi regime, Golub and Moran have linked Saudi Arabia's oil policy to its efforts to purchase advanced American military equipment. However, as explained in Chapter VII, Saudi oil policy in this period was clearly based on its own long-term economic interests, which also satisfied its long-term political interests including arms purchases from the United

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[43] John Kifner, "Saudi Voices Deep Gratitude on AWACS Vote," ibid., October 31, 1981, A10.

[44] Jim Muir, "The Middle East Situation," *Middle East Economic Survey* XXV, no. 3 (November 2, 1981): 8-9; Safran, *Saudi Arabia*, 375.

States. In this regard, it is hard to say that Saudi oil policy in this period was primarily designed to achieve a military goal regardless of its long-term economic interests. Unlike the situation in early 1979, the political divisions in the Arab world in this period, caused by the Soviet invasion of Afghanistan and the Iran-Iraq War, gave the Saudi regime room to maneuver among its Arab neighbors in implementing its own foreign and oil policies. This environment enabled Saudi Arabia to conduct an oil policy based on its long-term economic interests in a direction that would enable it to achieve its political goals. Coincidentally, an agreement on American arms sales could meet at the intersection of a Saudi oil policy based primarily on its own economic interests and an American policy in the Middle East based on Reagan's political interests.

The Reagan administration understood that Saudi oil policy in this period was the outcome of Saudi Arabia's economic interests. Douglas Feith of the National Security Council (NSC) staff wrote extensively about Saudi oil pricing policies and related matters in the *Wall Street Journal* on March 30, 1981. He concluded that Saudi Arabia's oil policy derived from its own economic interests based on budgetary requirements, in spite of the claim that the Saudis were producing more oil than they needed into order to stabilize the Western economy. According to Feith, the Saudis argued that they would gain more profits if they reduced oil production, which would result in higher oil prices, sufficient to compensate for the production cut. However, in his estimation, it would be difficult for the Saudis to expect higher oil prices with their production cut, if total world supplies remained plentiful, and if Iran and Iraq were to add 7 million b/d to world supplies as Yamani had predicted in the *Post* article. Therefore, any talk of a Saudi oil production cutback should be regarded as an empty threat and the US government did not need to give the Saudis any political rewards. He summarized Saudi oil policy as follows: "Whether those rulers are 'pro-Western', friendly or pleased with any or all of the elements of US foreign policy is an issue linked to Saudi oil policy only in diplomatic rhetoric and in the minds of those who do not actually bear responsibility for turning Saudi oil into money."[45] At that time, the Reagan administration widely shared this opinion,[46] so that when Saudi Arabia announced that it would build a strategic petroleum reserve near Yanbu' in October 1981, the Reagan administration decided not to show the Saudis any gratitude, because the decision was taken in accordance with their own national interest in maintaining a steady inflow of petrodollars, however beneficial it may have been to the US.[47] The Reagan administration regarded any hostile comments by Saudi officials on their oil policy towards the West as so much empty diplomatic rhetoric and it did not hesitate to further an oil policy of its own based on neoliberal economic principles, encouraging market forces to take over the oil market in the 1980s.

The Background of Saudi Oil Policy as a "Swing Producer"

Although officials in the Reagan administration generally understood that Saudi Arabia's oil policy was based on its own economic interests, they seem to have regarded "Saudi Arabia's economic interests" simply as equivalent to satisfying the state's

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[45] Feith, "Saudi Production Cutback," 22.

[46] Memo, Richard V. Allen to James B. Edwards, June 1, 1981, folder "Oil (1981)," box 81, Executive Secretariat, NSC: Subject File, Ronald Reagan Library; Memo, Richard V. Allen to Vice President, Ed Meese and Martin Anderson, June 3, 1981, folder "Oil (1981)," box 81, Executive Secretariat, NSC: Subject File, Ronald Reagan Library.

[47] Memo, Douglas J. Feith to Richard V. Allen, October 26, 1981, folder "Oil (1981)," box 81, Executive Secretariat, NSC: Subject File, Ronald Reagan Library.

budgetary requirements. They also understood that an oil policy based on moderate oil prices reflected Saudi Arabia's political interests, which at the time included gaining political rewards from the United States.[48] On June 4, 1981, when the oil market was clearly experiencing structural changes, William Safire wrote an essay in the *New York Times* about the current glut on the oil market. He argued that this was mainly due to the high prices engineered by OPEC and that the US government should take strong action to crack the OPEC cartel, suggesting four effective ways to deal with it.[49]

The administration paid close attention to this essay at that time[50] and seems to have considered that current market conditions provided a good opportunity to break OPEC. The analysis by US officials in the early 1980s that the main priority of Saudi oil policy was to satisfy its own budgetary requirements might have led them to believe that it would be easy to break the power of OPEC in the near future, given the state of market forces under a slack market condition. If Saudi Arabia's main aim was to meet its budgetary requirements, it would produce more oil, which would promote competition among OPEC members by discounting their own oil, and this would eventually result in the demise of OPEC. The Reagan administration probably anticipated all these developments, given the increasing influence of market forces on the world oil market. However, Saudi Arabia tried to prevent prices from collapsing by adopting the role of

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[48] Memo, Douglas J. Feith's Report to John M. Poindexter, February 23, 1982, folder "Oil (January 1982-March 1982)," box 81, Executive Secretariat, NSC: Subject File, Ronald Reagan Library. See Douglas J. Feith's article in Policy Review (Winter 1981).

[49] William Safire, "Gluts to the Gluttons," *New York Times*, June 4, 1981, A23.

[50] Memo, Douglas J. Feith to Richard V. Allen, June 4, 1981, folder "Oil (1981)," box 81, Executive Secretariat, NSC: Subject File, Ronald Reagan Library.

"swing producer" within OPEC.

In addition to the structural changes in the world oil market during the 1980s, political events in the Middle East, particularly the Iran-Iraq War, led Saudi Arabia to take a role as the "swing producer" within OPEC in response to the increasing challenges of market forces.[51] As Robert Mabro's analysis suggests, structural changes in OPEC supplies encouraged Saudi Arabia to play an increasing role within the organization. Mabro explained that until 1979, OPEC consisted of two large producers (Saudi Arabia and Iran), four middle-sized members with an output of around 2 million b/d (Iraq, Kuwait, Venezuela, and Nigeria) and seven smaller producers. However, Saudi Arabia eventually became the only large producer and none of the middle-sized members was still producing 2 million b/d in 1982. The declining production of Iran and the four middle-sized members of OPEC meant that the only country within OPEC capable of taking the burden of output adjustment to defend oil prices was Saudi Arabia.[52] Other influential countries, particularly Iran and Iraq, could not cooperate with Saudi Arabia, because they wanted to produce their oil as much as possible in order to finance their war.

As explained in the previous chapters, one of the main reasons why Saudi Arabia took on this role was because it wanted to maximize the long-term economic value of its

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[51] Some authors argue that the role of swing producer during the first half of the 1980s assumed by Saudi Arabia began in March 1982 with the introduction of output sharing for the first time in the history of OPEC; others see the London Agreement of March 14, 1983 as a starting point because no specific quota was allocated for Saudi Arabia to act as a swing producer. Although Saudi Arabia's quota was 7 million b/d in March 1982, it produced less than its quota in order to defend the official marker price of $34/b. Therefore, it is more reasonable to assume that Saudi Arabia began its swing producer role in March 1982.

[52] Robert Mabro, "Can OPEC Hold the Price Line?" *Middle East Economic Survey,* Supplement to XXV, no. 21 (March 8, 1982): 3.

oil by setting world prices through OPEC. The characteristics of the Saudi oil industry generally encouraged the regime to play the role of a "swing producer" in order to control oil prices. However, since the late 1970s, the influence of market forces had increasingly challenged Saudi Arabia's dominant position as a price setter. It became difficult for it to oblige other OPEC members to stay within the organization's pricing system in the early 1980s. In an attempt to regain its position as a price setter, Saudi Arabia continuously increased its production, which gave market forces little room to agitate the world oil market, while it was obliged to raise its own prices to reunify OPEC's oil prices. Although Saudi Arabia achieved price unification at $34 a barrel in October 1981, continuing structural changes in the world oil market, particularly the increasing production of non-OPEC suppliers, seriously undermined the whole pricing structure of OPEC early in 1982. This meant that Saudi Arabia's position as a price setter was once again in jeopardy. In this slack market, it was natural that it should take on the role of "swing producer" to secure its long-term economic interests by reducing its production dramatically.

In spite of the high possibility that the implementation of Saudi Arabia's oil policy as a "swing producer" in a slack market might have undermined three political principles (the regime's reliance on its Wahhabi supporters, its alliance with the West and its capacity to act as a rentier state), which gave it enhanced political stability, Saudi leaders accepted this role in the short-term, because the restoration of the country's position as a price setter would ultimately be in line with its long-term political interests. In fact, while it was playing its swing producer role in the first half of the 1980s, its leaders could manage all these short-term political problems except the increasing vulnerability of its capacity to act as a rentier state. As explained in Chapter IV, the Saudi government did not hesitate to support the Muslim establishment to enhance its political legitimacy in spite of its economic difficulties during this period. On the other hand, although the US administration had different interests in Saudi Arabia's oil policy as a swing producer, this issue was unlikely to threaten the political stability of the regime, because both countries had many shared political interests in the Middle East. In addition, the Saudi government could sustain its rentier economy, at least for a while, by using its huge foreign reserves. However, as this painful oil policy continued for longer than the Saudi people expected, the government's principal function, to distribute the oil wealth across society and the economy, diminished considerably. All these developments provoked considerable domestic dissatisfaction and finally led the government to abandon its three-year-old policy. This issue will be discussed in the next section.

There were relatively little pressures on Saudi oil policy as a swing producer from the neighboring Arab countries, and Saudi Arabia had little room at the time to use its oil policy to achieve its regional political goals. Al-Yousef argues that increased pressure from Arab countries, particularly Algeria, Iran Libya, and Iraq, was one of the main reasons that led Saudi Arabia to assume the role of a swing producer.[53] However, her argument is less persuasive since it seems to ignore the contemporary political context in the Middle East. Since late 1979, Saudi Arabia had been enjoying increasing autonomy in its oil policy, continuously producing at almost maximum levels for about two years in spite of opposition from other OPEC members. Furthermore, no critical political events occurred which might have caused Saudi Arabia to redirect its oil policy

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[53] Al-Yousef, "The Role of Saudi Arabia," 67.

at the expense of its long-term economic interests. Although the Iran-Iraq War entered a new phase in early 1982 and Saudi Arabia might have felt some degree of urgency at the prospect of Saddam Husayn's defeat in the near future, there was not much that Saudi Arabia's oil policy could do to affect the situation. Fortunately, the Iranian offensive into Iraq in the middle of 1982 failed and the Iran-Iraq War entered another long period of attrition.[54] Even in the crucial circumstances of the 1982 Lebanon War, Saudi Arabia's oil policy was relatively free from pressure from its the Arab neighbors. In contrast with the political situation in 1973 and early 1979, the Iran-Iraq War brought about divisions among the Arab states. Iraq was involved in its war with Iran and was desperately in need of financial and military support from the Gulf countries, while Syria's dogged support for Iran isolated the Assad regime in the Arab world. Israeli military operations in Lebanon and Syria's inability to save the PLO from disaster in Beirut in the middle of 1982 affected Syria's leadership in Arab politics. Although there was pressure on Saudi Arabia from some Arab countries to use the oil weapon in reaction to the war in Lebanon in 1982, the slack market situation meant that any such action would not be effective. In addition, Saudi Arabia had already reduced its output considerably and it did not need to upset its relationship with the United States, which was effectively protecting its skies and securing its oil transit routes.[55] Considering all these developments, political factors barely affected Saudi oil policy in this period. Although Saudi oil policy as a swing producer generally supported the economic interests of the neighboring Arab countries, they were not in a position to press the Saudi government to take this role. Furthermore,

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[54] For the details of this political event, see Safran, *Saudi Arabia*, 340-41, 76, 81-85, 418-19.

[55] Ibid., 343-44.

as Saudi Arabia's oil policy as a swing producer also satisfied the economic interests of all the members of OPEC, there was no serious pressure on Saudi Arabia to give it up.

Although Saudi Arabia's oil policy was adopted primarily to satisfy its long-term economic interests, there was one remaining question as to why it should have tried to achieve relatively high oil prices at the expense of its economy for such a long time. Although it could achieve its long-term economic interests by keeping oil prices low, which would not undermine its long-term economic interests, it did not always follow this strategy. Since non-OPEC production was seriously challenging OPEC's unified pricing system, keeping oil prices low to discourage non-OPEC producers, which usually required higher exploration and production cost than those of OPEC members, needed to follow some sort of economic logic. Furthermore, in spite of accumulating a huge financial deficit, Saudi Arabia always tried to maintain relatively high oil prices over three years, a course of action that cannot be answered simply with reference to the dominant producer model.

To answer this question, first, we should understand how Saudi oil policy makers regarded the world oil market. Born and raised in a religious family,[56] Yamani considered that the world oil market was going though a power struggle between OPEC and market forces, representing, respectively, virtue and vice. He and his colleagues believed that the increasing influence of market forces would not only endanger their long-term economic interests, but also would make the world economy suffer permanently from cyclical energy crises. They believed that Saudi Arabia's oil policy as a swing producer was the only way of controlling oil prices through OPEC against the onslaught of market forces,

[56] Jefferey Robinson, *Yamani: The Inside Story* (New York: A Morgan Entrekin Book, 1988), 39-41.

and that this would also prevent the collapse of the price structure. Yamani had negative opinions of market forces[57] and strongly believed that OPEC was the only organization capable of stabilizing oil prices. At a lecture at Kansas State University on March 28, 1983, he stated that "oil is too important a commodity to be left to the vagaries of the spot or futures market, or any other type of speculative endeavor. OPEC, despite its shortcomings, is still the best body to assume the role of price setter."[58] Saudi Arabia under Yamani's leadership was willing to defend an OPEC-controlled oil market against the increasing influence of market forces, even if doing so meant sacrificing its own economy. In reaction to a shift in North Sea oil pricing based on the market situation, Yamani told the official Saudi Press Agency on December 11, 1984, "both King Fahd's government in particular and OPEC in general have fought against the idea of leaving prices to be determined by the vicissitudes of the market, and in this regard we made great sacrifices."[59] Faced with the challenges of market forces, Saudi Arabia took a last stand in the battle to sustain the price structure of OPEC.

King Fahd seems to have shared Yamani's world-view, which coincided with his own political interests. In a radio broadcast on July 24, 1982, marking the end of

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[57] As explained in the section on "Saudi Oil Policy in Transition" in Chapter VII, Yamani's main concern since the late 1970s had been the increasing influence of market forces, which he believed would gradually replace OPEC's dominant position in the world oil market and threaten its very existence. Hence, he worked hard to avoid what he regarded as this catastrophic outcome. His enthusiasm for a long-term strategy for OPEC can be understood in this context.

[58] Petroleum & Energy Intelligence Weekly, "Yamani Pushes Case for Price Stability," *Petroleum Intelligence Weekly* XXII, no. 15 (April 11, 1983): 9.

[59] Middle East Petroleum and Economic Publications, "OPEC Ministers Warn that Proposed Switch in North Sea Oil Pricing Could Lead to Price War: Shaikh Ahmad Zaki Yamani (Saudi Arabia)," *Middle East Economic Survey* XXVIII, no. 10 (December 17, 1984): A4.

Ramadan, King Fahd made his first public statement after he had succeeded to the throne upon the death of King Khalid a few weeks earlier, commenting on oil policy as follows:

> Our oil policy will continue to be based on our interests and the interests of our future generations, and will not be deflected from its course by the temptation of temporary short-term benefits or by tendentious outside pressures. Time has proved the correctness of what we have said and the accuracy of our predictions, and if others had listened to us our collective power as Arabs and oil producers would not have been weakened.[60]

It is clear from this statement that Saudi oil policy was clearly designed to serve the state's long-term economic interests in this period, and that this policy would enhance Fahd's political leadership in domestic and Arab politics,[61] because he could position himself as having tried to defend the economic interests of OPEC suppliers in the face of the market forces represented by the West. As explained in the section on "Oil and Islam" in Chapter IV, Fahd had a bad reputation with his hedonist past and extravagant lifestyle. Therefore, in addition to increasing his support for the religious establishment both in Saudi Arabia and the world, this "principled" oil policy would enhance his own leadership, particularly within the GCC, and distract attention from his previous reputation.

Next, we have to grasp the fragile situation of the world oil market during this period. It was difficult for Saudi officials to prevent the world oil market from price collapse, which would certainly give market forces a golden opportunity to control it in

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[60] "King Fahd Makes First Policy Statement," *Middle East Economic Survey* XXV, no. 42 (August 2, 1982): 10.

[61] The continuation of this policy for a long time could provoke public opposition because of the economic hardships that accompanied it. However, in the short term, it would enhance King Fahd's political leadership in Saudi Arabia, because the Saudis were unlikely to experience serious economic difficulties as long as their huge foreign reserves compensated for the reduction in revenue.

the current slack market conditions. This development would fatally threaten the existence of OPEC, which would be very much at odds with Saudi Arabia's long-term economic interests. As shown in Chapter VII, Nigeria in particular had difficulty in staying within the OPEC pricing system because of uncontrolled competition from North Sea producers. It was clear that the secession of Nigeria from OPEC would have a domino effect on other OPEC members, and that this would have the effect of triggering the demise of the organization. That explains why Saudi Arabia put constant pressure on the major oil companies to increase their liftings in Nigeria during the spring of 1982 and left Nigeria out of OPEC's pricing system as an exceptional case at the Vienna Conference in March 1983. In spite of Saudi Arabia's efforts to keep members of OPEC within the organization's pricing system, it was difficult for it to control oil prices in this period mainly because of increasing production from non-OPEC producers and cheating by OPEC members on their production quotas via discounting their crudes on the world oil market. It was widely believed that oil prices would soon collapse and that the demise of OPEC was imminent. According to Aron Tussing of the University of Alaska, writing in *Public Interest* in the winter on 1983, "the cartel set the stage for its own destruction by pricing oil out of the market." According to his estimation, if there were to have been no cheating on the cartel price-fixing agreement among OPEC members, their sales would be even lower.[62] While the world oil market was suffering from a glut in the middle of 1984, many oil experts and institutions were worried about oil price collapse. An oil expert for the First Boston Corporation, William L. Randol, said, "Prices seem to be sinking daily," and Platt's Oilgram called the situation a "price collapse." *PIW* said,

[62] Hobart Rowen, "Cry Not for OPEC—Or the Banks," *Washington Post* January 26, 1983, A21.

“there was no bottom in sight to declines on the spot-oil market, where oil is sold for immediate delivery.”[63] In this emergency market situation, lowering oil prices to levels unacceptable to other OPEC members would only encourage them to sell widely on the spot market, which would have brought about a world price collapse. Although non-OPEC suppliers continuously harassed Saudi Arabia by increasing their output, thus undermining OPEC’s pricing system, Saudi Arabia could not punish them by lowering oil prices, because this would cause permanent damage to its own position as a price setter. Its only option was to sustain high oil prices and to wait until the non-OPEC producers gave in to its price leadership.

Another reason why Saudi Arabia pursued higher oil prices in this period could be understood by its anticipation of the future oil market. As we will see later, it anticipated that demand for oil would rise again and that the difficulties in the world oil market were only temporary. Thus, Saudi Arabia was preparing for a future energy crisis after the recovery of oil demand. As explained in the section on “Saudi Oil Policy in Transition” in Chapter VII, Yamani had a clear vision for the future oil market. In his opinion, oil prices should rise continuously without encouraging either depression or recession. He argued that low prices would not only encourage the demand for oil, but would also discourage both oil exploration in high cost regions and the development of alternative energy sources. Either or both developments would result in an energy crisis in the future and market forces would then determine world oil prices at much higher levels. However, these higher prices would bring about a small recession and a decrease in oil demand, and market forces would again determine the price of oil. Without

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[63] Stuart Diamond, "Gas and Oil Prices Unexpectedly Fall," *New York Times* July 3, 1984, D5.

maintaining oil prices at proper levels, this cycle of oil prices would continue and of course OPEC would have no power to control oil prices, being obliged to surrender this power to market forces.[64] Therefore, the best way to secure Saudi Arabia's long-term economic interests was to keep oil prices at levels it considered desirable. This understanding of the world oil market, particularly as envisaged by Yamani, led him to advocate a Long-Term Strategy for OPEC, which never materialized. He regarded $30 a barrel as the Maginot line that would secure Saudi Arabia's long-term economic interests. According to a team of consultants hired by Yamani, when oil prices stayed below $30 a barrel, it was economically impractical for the consuming countries to develop alternative sources of energy.[65] In this regard, Saudi Arabia should have aimed for $30 a barrel before the OPEC Conference in London in March 1983, which reached an agreement on price for Marker Crude at $29 a barrel because of the price war initiated by BNOC's price cut.[66] That is one of main reasons why Saudi Arabia tried to achieve relatively high oil prices in a slack market.

Saudi Arabia agreed on OPEC's production proration program in March 1982, which it had opposed for a long time, because policy makers wrongly anticipated that a chaotic market situation in early 1982 would be quickly tranquilized by the elimination of the oil surplus. Yamani seemed to believe that the unfavorable market conditions early in 1982 were temporary and that OPEC could regain its predominant position by

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[64] Yamani, "The Changing Pattern," 1-6; Middle East Petroleum and Economic Publications, "Yamani on French Television," ibid.XXII, no. 7 (December 4, 1978): i-iii; Ahmad Zaki Yamani, "The Outlook for Energy - The Year 2000," ibid.Supplement to XXII, no. 36 (June 25, 1979): 1-6.

[65] Robinson, *Yamani*, 239.

[66] See the section, "The Increase of Non-OPEC Production" in Chapter VIII.

implementing oil policy as a swing producer.[67] During an interview at a press conference in Vienna on March 20, 1982, Yamani said that he regarded the decision of the British government to reduce the price of North Sea oil to $31 per barrel as a strategy on the part of some major consumers to weaken the power of OPEC, and that he anticipated that prices would go up in the very near future.[68] In an interview in the Kuwaiti daily *al-Siyasah* on 29 March, 1982, Prince Fahd said that "Saudi experts expect the current oil surplus to end in the next two or three months."[69] The governor of Petromin was also confident that the market would reach equilibrium "in four to six weeks."[70] These inaccurate anticipations of world oil market trends led Saudi officials to agree to a production proration program in March 1982. Before this, Saudi Arabia had always rejected any OPEC production-planning scheme, making the excuse that decisions over oil production were matters for each country to decide. [71] However, Saudi officials were obliged to join a production proration program in early 1982, because price cuts by North

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[67] It is hard to exactly say that Saudi Arabia had assumed the role of swing producer since March 1982, because its production quota had been decided by OPEC at the Vienna Conference. However, in reality, as Saudi Arabia produced less than its allocated quota of 7.5 million b/d, it had virtually played the role of swing producer since March 1982.

[68] Middle East Petroleum and Economic Publications, "Shaikh Yamani's Press Conference," *Middle East Economic Survey* XXV, no. 24 (March 29, 1982): ii.

[69] "Saudi Arabia," *Middle East Economic Survey* XXV, no. 25 (April 5, 1982): 5.

[70] Petroleum & Energy Intelligence Weekly, "OPEC Cheered by Market Upswing before Quito Meeting," *Petroleum Intelligence Weekly* XXI, no. 20 (May 17, 1982): 3.

[71] As a dominant producer in the world oil market, Saudi Arabia wanted to decide its own production level without any interference from other OPEC members. It was clear that Saudi Arabia's long-term economic strategy would have been endangered if its production levels were determined by OPEC's production quota.

Sea producers threatened the whole price structure of OPEC. When they reluctantly accepted a production proration program at that time, they regarded it as a temporary measure to overcome a short-term crisis in OPEC's pricing system. In this regard, Taher, the governor of Petromin, declared at a gathering at Harvard University in May, "Saudi Arabia would never, never, go along with any production planning scheme."[72] As Saudi officials anticipated, if oil demand recovered and OPEC were to overcome this crisis in a short time, they would not join any production proration program.

Contrary to policy-makers' expectations, Saudi Arabia kept playing the role of swing producer because of their inaccurate anticipation of trends on the world oil market. In spite of its effort to eliminate any oil surplus, no price increase followed the recovery in the demand for oil, and OPEC was burdened with the high pressure of price cuts. Even after two years, Yamani believed that OPEC's market share would recover because of the promise of increased demand. In an interview with *MEES* on August 16, 1984, he forecasted, "the last quarter of this year will witness an increase in oil consumption and demand which will raise OPEC's share of the crude oil market to 19 million b/d or more."[73] Speaking to Saudi students in August, King Fahd, who shared Yamani's optimism, noted that the present situation was temporary and asked OPEC members to unite in the face of pressure from the industrialized countries to destroy the

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[72] Petroleum & Energy Intelligence Weekly, "Saudis Say Never to Joining OPEC Prorationing," *Petroleum Intelligence Weekly* XXI, no. 20 (May 17, 1982): 1; Since March 1983, Saudi Arabia had no any allocated quota, and decided its production level in accordance with the market situation.

[73] Middle East Petroleum and Economic Publications, "Yamani Confident OPEC Price Line Will Hold," *Middle East Economic Survey* XXVII, no. 45 (August 20, 1984): A1.

organization.[74] Prediction of a rise in oil consumption did not materialize, and OPEC was obliged to reduce its production ceiling from 17.5 million b/d to 16 million b/d in October 1984. Saudi Arabia continued to play its role as a swing producer until August 1985, in the vain hope that the market would soon recover from the slump. The strong belief that OPEC would re-emerge as a dominant organization in the near future and that Saudi Arabia would soon regain its position as a price setter led Saudi officials to continue their oil policy for over three years, largely at the expense of the Saudi economy.

The Internal and External Challenges to Saudi Oil Policy

Although the cooperation of OPEC members was essential to the success of Saudi oil policy as a swing producer in this period, Saudi Arabia generally failed to receive full support from other OPEC members. The Vienna Conference in March 1982 decided to establish the Ministerial Monitoring Committee—composed of the oil ministers of the UAE, Venezuela, Algeria and Indonesia—and to monitor market developments and the implementation of OPEC's decisions on production and prices. However, this committee had no binding powers to execute price and production decisions. Some member countries did not adhere rigidly to the quotas imposed by OPEC, and offered consumers price discounts on their crude oil. According to *PIW* calculations, a variety of covert price discounts dropped OPEC's average official prices from $32.90 to $32.40, recording another 50¢ or so off average per-barrel costs in 1982. Iran and Libya

[74] "Saudi Arabia: King Fahd Says Saudi Production Has Dropped to 4-4.25 Mn B/D," *Middle East Economic Survey* XXVII, no. 46 (August 27, 1984): A2.

regularly offered discounts through spot sales, barter deals and other means.[75] Iran succeeded in making a volume breakthrough in the oil market with its cut-price spot sales to Japanese and European buyers for delivery in April and May 1982.[76] It also completed negotiations on a $157 million barter deal for car kits with Talbot Motor Company of the UK in 1985.[77] Other member countries followed suit, exporting more oil regardless of their quotas. By the middle of July 1982, Venezuela and Libya produced more oil than their assigned quotas, undermining OPEC harmony and threatening the OPEC production ceiling.[78]

With declining oil demand, weak prices and soaring debt, the financial situation of some OPEC members, particularly Nigeria and Venezuela, became extremely precarious. To overcome its financial difficulties, Nigeria was obliged to cut oil prices in order to boost its sales. Iraq was suffering serious financial problems. Its currency reserves had plummeted to less than $1 billion in 1983 from $25 billion in 1980. It had debts of approximately $25 billion to its Arab neighbors, probably about $15 billion to Saudi Arabia. Iran's financial situation was better than many other OPEC countries because of its aggressive sales policy. With decreasing oil revenues, budget and trade deficits became commonplace throughout the Middle East. Most OPEC members

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[75] Petroleum & Energy Intelligence Weekly, "Discounting Cuts Average Price of OPEC Crude by 50¢," *Petroleum Intelligence Weekly* XXI, no. 49 (December 6, 1982): 1.

[76] Middle East Petroleum and Economic Publications, "Iran Makes Big-Volume Spot Sales," *Middle East Economic Survey* XXV, no. 27 (April 19, 1982): 3.

[77] "Iran: Barter Deal for Car Kits," *Middle East Economic Survey* XXVIII, no. 26 (April 8, 1985): A5.

[78] "OPEC Production Balance Looks More Fragile Following Output Increases in Venezuela and Libya," *Middle East Economic Survey* XXV, no. 41 (July 26, 1982): 1.

resorted to austerity measures to compensate for reduced oil revenues.[79] In a slack market, the majority of OPEC producers were not in a position to abide by their own quotas because of their increasing financial plight.

To defend the official OPEC marker price ($34 in 1982 and $28-$29 in 1983-85) against the pressure of declining oil prices, Saudi Arabia strongly opposed discounts on OPEC members' crude oils and asked them to observe their production quotas. However, Saudi Arabia also suffered from the widespread cheating on both price and production levels among OPEC members and had difficulty in defending the marker price without their full cooperation. Even the OPEC "moderates" exceeded their production quotas and asked Saudi Arabia to make further production cuts.[80] In response to questions from *MEES* at a pre-OPEC conference in December 1982, Yamani made it clear that Saudi Arabia could effectively defend the marker price if price and production discipline was restored within OPEC. He asked OPEC members to avoid discounting and other forms of price-cutting, to observe production quotas, and to correct differentials.[81] Although price and production discipline among OPEC members was a primary condition for the success of OPEC against the increasing influence of market forces and challenges from non-OPEC producers, most OPEC members, suffering from a huge reduction in oil revenues, were unable to free themselves from the temptations to resort to discounts on the spot

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[79] Petroleum & Energy Intelligence Weekly, "Loss of Billions in Oil Revenue Still Plaguing Exporters," *Petroleum Intelligence Weekly* XXII, no. 41 (October 10, 1983): 1-3.

[80] Cable, US Liaison Office in Riyadh to Secretary of State, August 29, 1982, Department of State.

[81] Middle East Petroleum and Economic Publications, "Saudi Support for $34/B OPEC Marker Crude Price is Conditional on Restoration of Price and Production Discipline," *Middle East Economic Survey* XXVI, no. 10 (December 20, 1982): A1-2.

market.

Furthermore, price cuts from non-OPEC suppliers also seriously challenged the whole OPEC pricing system during the 1980s. As explained in Chapter VIII, it was impossible to ignore the increasing production of non-OPEC producers during the 1980s, when it began to overtake OPEC production. Non-OPEC production became one of most important factors determining the price of oil on the world oil market, undermining the dominant position of OPEC. In spite of a reduction in OPEC production, the continuously increasing output of non-OPEC suppliers, particularly North Sea producers, made the oil glut even worse, forcing oil prices downward. In an attempt to secure their oil production, they cut prices preemptively, eroding the whole structure of the OPEC pricing system.

Mainly due to the failure to achieve unity and cooperation among all oil exporters, both OPEC and non-OPEC suppliers, Saudi oil policy in the 1980s required huge cuts in oil production for much longer than had been expected. By August 1985, Saudi Arabia had absorbed over 50% of OPEC's production cutbacks since the late 1970s. Before it took on the role as a swing producer in March 1982, its output had been 8.64 million b/d in February alone. However, its production fell dramatically to 2.2 million b/d in August 1985, making a total cutback of 6.44 million b/d from production in February 1982. OPEC output fell from 19.869 million b/d in February 1982 to 14.850 million b/d in August 1985, amounting to a 5.019 million b/d cutback, which was less than the output cutback of Saudi Arabia during the same period.[82] This meant that some member countries produced more oil in August 1985 than in February 1982, although these gains

[82] Petroleum & Energy Intelligence Weekly, "PIW's Month-by-Month Breakdown of Free World Crude Oil Production for 1979," *Petroleum Intelligence Weekly* XIX, no. 5 (February 4, 1980): 9; "PIW's Month-by-Month Breakdown for 1982," 8; "PIW's Estimated Tally for 1985," 10.

came at the cost of reductions in Saudi output. Some members, particularly Iran and Iraq, produced well above their own production quotas during that time.

Saudi oil policy-makers' attempts to control oil prices through OPEC over these three years brought about huge economic difficulties, and there was growing internal dissatisfaction both from members of the royal family and the Saudi population as a whole. As a result of the huge decrease in oil output, Saudi oil revenues dropped from 328,594 million Saudi riyals (SR) in 1981 to 88,425 million SRs in 1985, recording national account deficits of 23,766 million SRs in 1983, 44,854 SRs in 1984, and 50,439 SRs in1985.[83] In addition to the increasing absorptive capacity, the deficit in governmental finances led the Saudi government to sell off its foreign assets at a rapid rate; they dropped from $137.7 billion in 1982 to $87.7 billion in 1985.[84] During this period, foreign exchange reserves were being drawn down at a rate of $1.0 to $1.5 billion per month simply to sustain government spending.[85] By 1986, facing this continuing decline in its oil revenues, the government progressively reduced its annual budget to just over half of its size in 1982/83, from $91 million in 1982/83 to $45 million in 1986. The recession reduced the number of jobs in the private sector and brought about a sharp drop in the incomes of the business class. Thousands of companies faced cash-flow difficulties

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[83] Saudi Arabian Monetary Agency, "Forty-First Annual Report."

[84] Niblock and Malik, *The Political Economy of Saudi Arabia*, 57.

[85] Briefing Memorandum, Frederick N. Khedouri to Vice President, March 28, 1986, folder "The Vice President's Trip to the Persian Gulf and Arabian Peninsula, April 3-12, 1986 [Briefing Book] (2)," box 91688, Near East and South Asia Affairs Directorate, NSC Records, Ronald Reagan Library.

and went bankrupt.[86] The middle-income class also experienced economic hardships, while prices for petroleum products and electricity were raised and access to interest-free housing loans became much more difficult. Young Saudis faced tougher employment prospects and were offered reduced wages. Although spending cuts in the military were less dramatic than in other sectors, individual officers and enlisted personnel experienced real falls in their income. Wheat subsidies for farmers were reduced in late 1984, and payments for deliveries had been late for the past three harvests.[87] By 1984 there was increasing pressure from the Association of Chambers of Commerce and industry on the government to give up the country's role as a swing oil producer. Although the Association's attempt was unsuccessful, it begged King Fahd to disregard OPEC and to increase oil production, which would permit an increase in government spending.[88]

In this harsh economic situation, some ministries, including the Ministry of Finance and the Ministry of Defense, began to undermine the ability of the Ministry of Petroleum and Mineral Resources to implement its oil policy. The Ministers of Finance and Defense gradually succeeded in persuading King Fahd to make decisions that challenged Yamani's policy. Domestic refinery projects driven by Yamani were cancelled and barter deals, which Yamani opposed, were concluded without involving him in the decision-making process. The state's segmented bureaucratic system meant that the autonomy of the Ministry of Petroleum and Mineral Resources could be restricted dramatically.

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[86] Abir, *Saudi Arabia in the Oil Era*, 179-80.

[87] Cable, American Embassy in Riyadh to Secretary of State, American Consul in Dhahran and American Consul in Jeddah, March 8, 1986, Department of State.

[88] Abir, *Saudi Arabia in the Oil Era*, 182.

By early 1985, the unpopularity of the continuing financial austerity allowed the Minister of Finance, Sheikh Muhammad Abalkhail, to seize greater power within the Council of Ministers, reducing Yamani's ability to support his own oil policy over the course of 1984. Sometime in this period, Abalkhail managed to persuade King Fahd to move a portion of Aramco's capital account into the general reserve. This account, a key source for major capital projects, had grown consistently and was worth around $10 billion in 1984. However, over $4 billion was transferred from Aramco's capital account to the Saudi Arabian Monetary Authority (SAMA) for the refurbishment of the shrines in Mecca and Medina in late 1984. This created a precedent for further transfers in 1985 and 1986, although neither of these transfers was linked to a specific project. In addition to the Aramco account, a similar but much smaller account for Petromin was also outside Yamani's control, restricting his financial ability and prestige, which had been so necessary for his ability to conduct his policies without interference from other ministers. As Yamani's financial resources were part of the national budget, the development of the oil industry that he had masterminded was now subject to Abalkhail's authority. Yamani could no longer enjoy oil policy autonomy, because he needed the support of other ministers for his oil policy and related projects.[89]

For the successful implementation of long-term Saudi oil policy both as a residual supplier and a price settler in the world oil market, the development of petrochemicals became crucial in developing an additional source of revenue. In an interview in the Saudi weekly *al-Yamamah* on April 27, 1983, Yamani argued that Saudi

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[89] Cable, American Embassy in Riyadh to Secretary of State, June 25, 1986, folder "Saudi Arabia," box 90998, Lucian S. Pugliaresi Files (1986-1988), Ronald Reagan Library.

Arabia should eventually reduce its dependence on oil by diversifying its sources of income. He seemed to believe that this diversification would secure his autonomy and allow him to implement his long-term oil policy, which would require time for completion, possibly into the 1980s and 1990s. To achieve this goal, he regarded the development of the petrochemical industry as a necessary condition, claiming, "the petrochemical industry is essential for the country and we must build it."[90] His promotion of refinery projects was strengthened by the fact that the demand for refined products in Saudi Arabia exceeded government projections in 1982 and a shortfall was anticipated as early as 1984. Therefore, new domestic refineries were planned, as well as the expansion of established refineries.[91]

Pressure from the Minister of Finance frustrated Yamani's attempts to promote the petrochemical industry. Aramco, which had supervised the project on behalf of Petromin, notified the prime contractor, Bechtel, in March 1983 that they were cancelling the Qasim refinery project, although its construction was already quite far advanced. A 160,000 b/d domestic refinery had been planned, and in addition, the construction of a 150,000 b/d refinery at Shuqaiq was postponed indefinitely. According to *MEES*, the cancellation of the Qasim refinery and the continued postponement of the Shuqaiq plant were largely the result of the increased influence of the Ministry of Finance, which was

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[90] Middle East Petroleum and Economic Publications, "Yamani Confident that Present Oil Price Will Hold," *Middle East Economic Survey* XXVI, no. 29 (May 2, 1983): A11-12.

[91] "Saudi Arabia: Petromin Approves Two New Domestic Refineries in Central and Southern Provinces," *Middle East Economic Survey* XXV, no. 44 (August 16, 1982): 3-4.

cutting back expenditure on oil projects.[92] Although Yamani and Petromin Governor Taher tried hard to save the Qasim domestic refinery project, Abalkhail's views prevailed in the Council of Ministers. The cancellation of the refinery project required the government to pay hundreds of millions of dollars in penalties to contractors, and even a personal appeal from Yamani to King Fahd could not save the project.[93] The austere economic situation caused by Yamani's oil policy resulted in the rise of Abalkhail and his increasing authority within the Saudi cabinet. Yamani's projects, which required huge amounts of capital, were under the scrutiny of the Ministry of Finance, regardless of their importance for his long-term oil policy. After losing his financial power to Abalkhail, Yamani's independent capacity to implement his oil policy independently was severely undermined.

Furthermore, Yamani had difficulties in consistently advancing his oil policy, because the Minster of Defense, Prince Sultan, also infringed on his autonomy. The *Washington Post* reported in July 1984 that Boeing and Rolls Royce had reached agreement in principle with the Saudi government to barter aircraft and engines for oil, a deal worth $1 billon. This barter deal involved the purchase of ten Boeing 747 aircraft (the price for each was nearly $100 million) and fifty Rolls-Royce RB-211 engines in exchange for Saudi oil. The deal was concluded by Saudia, the national airline, on behalf of the Ministry of Defense, which wanted to use the aircraft as troop carriers and

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[92] "Saudi Arabia: Saudi Arabia Cancels Qasim Refinery Project," *Middle East Economic Survey* XXVIII, no. 23 (March 18, 1985): A4.

[93] Cable, American Embassy in Riyadh to Secretary of State, June 25, 1986, Department of State.

transport planes.[94] According to *MEES*, Petromin was supposed to pay for the deal with oil revenues. Yamani made it clear that this deal would be an exceptional case and that Saudi Arabia would not change its general policy of opposition to oil barter transactions.[95] The volume of Saudi crude involved in the deal apparently amounted to some 34 million barrels, composed of 50% Arabian Light, 30% Arabian Medium and 20% Arabian Heavy. The total sale price for the ten aircraft at the current price was about $920-950 million and the sale price of the engines was approximately $90-100 million. Although the government argued that the oil would change hands at official prices, Tokyo reports said that the oil barter would be paid at the going market price or even a little below,[96] thus involving a major breach of Saudi Arabia's steadfast adherence to OPEC production and pricing discipline. Although Yamani clearly opposed barter deals, he could not stop these activities because of the increasing influence of some members of the royal family, particularly the Minister of Defense Prince Sultan and his allies, on oil policy during this period of austerity.[97]

It was not the Ministry of Petroleum that had authority to decide barter deals in the mid-1980s, but the Ministry of Defense. Prince Sultan persuaded King Fahd to take this decision and Yamani, who was principally in charge of Saudi oil policy, was

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[94] Staff Reports and News Services, "Boeing, Rolls-Royce Barter for Saudi Oil," *Washington Post,* July 19, 1984.

[95] Middle East Petroleum and Economic Publications, "Saudi Arabia: Proposed Oil for Aircraft Deal Would Be Exceptional Case Says Yamani," *Middle East Economic Survey* XXVII, no. 40 (July 16, 1984): A7.

[96] "Saudi Oil for Aircraft Deal Moves Ahead," *Middle East Economic Survey* XXVII, no. 41 (July 23, 1984): A2.

[97] Cable, American Embassy in Riyadh to Secretary of State, June 25, 1986, Department of State.

excluded from the decision-making process. After the 1984 barter deal, there were false rumors regarding deals for French Mirage fighter aircraft and Brazilian weapons. At the end of 1985, however, another barter deal materialized. Saudi Arabia decided to purchase the Tornado aircraft package by selling Saudi crude directly to the British oil companies BP and Shell. Although Yamani had stated earlier that the Tornado deal would not be financed by bartering Saudi oil, he was unable to check the growing influence of Prince Sultan, who was keen to make the deal.[98]

While Yamani steered Saudi oil policy as a swing producer for three years under slack market conditions, his policy faced internal and external challenges, frustrating his efforts to rearrange the world oil market on his terms. For the success of his policy, he needed price and production discipline within OPEC and the cooperation of non-OPEC suppliers. He failed to secure unity and cooperation among the oil producing countries and his forecasts of a rapid upturn in the oil market turned out to be inaccurate. Without any positive signals from the market, the continuation of Saudi Arabia's function as a swing producer for a long time was enough for other ministers and the population at large to discredit his oil policy. The increasing challenges to his policy came to a crescendo in the summer of 1985, and finally led him to discard it.

The 1985-1986 Oil Price Collapse

In terms of the price collapse in 1986, initiated by Saudi Arabia's abandonment of its policy as a swing producer, some researchers, such as Kengor and Schweizer, have tried to explain that this development was a conspiracy between Saudi Arabia and the

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[98] Ibid.

United States against the Soviet Union. According to their argument, Saudi Arabia played an important role in Reagan's campaign of economic warfare against the Soviet Union by making radical increases in oil production. As the Soviet economy had relied heavily on energy exports for hard currency, the oil price collapse of 1985-1986, mainly triggered by Saudi Arabia's decision to increase its production in order to recover its market share, contributed to the devastation of the Soviet economy.[99] In the context of the Cold War, when Saudi Arabia cooperated with the United States by supporting anticommunist resistance and counter-revolutionary insurgencies in Afghanistan and Nicaragua, the argument seems plausible, although they failed to provide clear evidence of cause and effect. For example, if there was an agreement with the US to defeat the Soviet Union economically, why did it happen in the middle of 1985 and why had Saudi Arabia sustained relatively high oil prices over the previous three years? If there had been a conspiracy between two countries to achieve a victory in the economic war against the Soviet Union, what would have been Saudi Arabia's reward? In this crucial moment, unlike in the case of the AWACS sale, Saudi Arabia was unable to buy more F-15s or to acquire advanced attack mission capability from the United States, because of Congressional opposition. As a result, Saudi Arabia reached an agreement with the UK in September 1985 for sixty Tornado ADV air defense fighters, sixty Tornado IDS/GR.1 attack strike-fighters, light attack aircraft, trainers, helicopters, munitions, and British

[99] Paul Kengor, *The Crusader: The Ronald Reagan and the Fall of Communism* (New York: Harper Perennial, 2007), 250-56; Peter Schweizer, *Victory: The Reagan Administration's Secret Strategy that Hastened the Collapse of the Soviet Union* (New York: The Atlantic Monthly Press, 1994).

support services.[100] If there was a desirable price level for the success of the economic war against the Soviet Union, what was it? In August and October 1986, in the middle of the price war, all OPEC members agreed to reduce production to defend falling oil prices. How could any conspiracy theory explain this?

Saudi Arabia and the United States did not have a shared view of a desirable oil price for their common political interests. In fact, there were different opinions on oil prices within the United States. While some oil companies, like Sun Oil, which had a surplus of refining and distribution capacity compared to their reserves of crude, together with oil consumers and the US Department of Treasury, preferred lower oil prices, oil companies such as Socal and Texaco, which had limited distribution and refining capacity compared to their substantial reserves, most American banks, and the US Federal Reserve did not want a major fall in oil prices. Therefore, there was no single American position on oil prices but several.[101] During the first quarter of 1986, after Saudi Arabia's decision to give up its role as a swing producer, the price of oil began to fall very rapidly. The average price of Arabian Light 34° fell to $12.90 per barrel in March 1986 from $27.35 in August 1985.[102] In the middle of the price war in 1986, Vice President George H. W. Bush visited the Arabian Peninsula, including Saudi Arabia, on April 3-12, 1986. In the document from the Ronald Reagan Library detailing Bush's visit to Riyadh it is clear that the Reagan administration had prepared talking points for his

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[100] Anthony H. Cordesman, *Saudi Arabia Enters the Twenty-First Century: The Military and International Security Dimensions* (Westport: Praeger, 2003), 217-18.

[101] Terzian, *OPEC*, 330-33.

[102] Petroleum & Energy Intelligence Weekly, "Tracking the Oil Price Collapse of 1985-86: Special Supplement," *Petroelum Intelligence Weekly* XXV, no. 16 (April 21, 1986): 1.

meeting with Yamani. This document was intended to help Vice President Bush explain that the Reagan administration had no preconceived notions on oil prices except that they should be preferably determined by the free market, operating without government intervention. It also indicated that the positive effects of lower oil prices for the world economy would outweigh any negative effects.[103] There were rumors that Bush tried to persuade Saudi Arabia to prevent the world oil market from collapsing during his visit to Saudi Arabia in 1986, but there is no evidence of its proof. According to the document, declassified in 2006, the Reagan administration was indifferent towards the price collapse in 1986 and it unswervingly adhered to the philosophy of the free market. It was clear that there were no pre-orchestrated oil prices between the two countries. Hence the suggestion that the 1985-86 price collapse was the result of a conspiracy between Saudi Arabia and the United States against the Soviet Union is completely ahistorical.

By August 1985, Yamani's hopes of controlling oil prices through OPEC were fading fast. To defend the whole structure of OPEC's pricing system in circumstances of a slack market, Saudi Arabia would at least have needed to secure the full cooperation of the non-OPEC suppliers, and to have organized strong price and production discipline among OPEC members. However, it failed to persuade either of them to follow its guidelines for the benefit of the world economy. More seriously, general anticipations of the future oil market were gloomy, which made it more difficult for Saudi Arabia to continue its oil policy. These developments had a devastating effect on the Saudi economy, causing severe internal dissatisfaction at Yamani's self-sacrificing oil policy

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[103] Memo, John C. Whitehead to the Vice President, March 28, 1986, folder "The Vice President's Trip to the Persian Gulf and Arabian Peninsula, April 3-12, 1986 [Briefing Book] (2)," box 91688, Near East and South Asia Affairs Directorate, NSC: Records, Ronald Reagan Library.

that was directed towards maintaining the existence of OPEC. By the summer of 1985, the only option for the Saudi government was to give up its role as a swing producer, which was no longer in its long-term economic interest.

When North Sea producers introduced a market-related oil policy early in 1985, Saudi Arabia completely failed to secure the cooperation of the non-OPEC countries. This became a major factor in influencing oil prices and such cooperation would have also enhanced solidarity within OPEC.[104] According to Mabro, the world petroleum market early in 1985 consisted of two blocs, represented, respectively, by OPEC members and the United States. While the former tried to control oil prices, the latter relied on the free market. The UK and the North Sea producers were positioned at the junction of these two worlds.[105] In this constellation of the world oil market, the decisions of Norway and Britain to follow a market oriented oil policy constituted a huge blow to OPEC.

The solidarity of OPEC deteriorated very considerably during 1985. The participation of non-OPEC producers in a market oriented bloc represented by the United States made it much more difficult for members of OPEC to observe its fixed prices and production allocations. Without securing the full cooperation of non-OPEC countries in a slack market, OPEC members were never free of the temptation to discount their oil or to violate their production quotas. As a number of OPEC members quietly boosted their output by discounting their oil in various ways, Saudi Arabia's production fell below its quota of 4.35 million b/d and fell even further, to around 2.5 million b/d in the middle of

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[104] See the section on "The Increase of Non-OPEC Production" in Chapter VIII.

[105] Petroleum & Energy Intelligence Weekly, "Rethinking Britain's Role in World Markets," *Petroleum Intelligence Weekly* XXIV, no. 11 (March 18, 1985): 7.

1985. Saudi Arabia could no longer rely on unity and cooperation among OPEC members. According to the *Financial Times*, “There is little more than wishful thinking behind the fashionable belief that the oil cartel is certain to collapse through the action of some immutable law of market economies.”[106]

The pessimistic forecast for the demand of OPEC oil in 1985 made it even more difficult for Yamani to maintain his policy of keeping Saudi Arabia as a swing producer. According to a majority of major oil company analysts surveyed by *PIW* in January 1985, OPEC would face a virtually uninterrupted period of depressed demand for the next eighteen months or more. The latest forecasts in April 1985 predicted a further cut in OPEC crude output, less than 15 million b/d for the third quarter, implying that prices would be remain weak or continue to slide without strong corrective action. Even if all the fundamental factors were working in OPEC’s favor, it would be difficult to expect OPEC’s output to exceed 16.5 million b/d for the remainder of 1985.[107] Given that many oil experts anticipated low demand for OPEC oil and low prices even after securing production and price discipline from its members, Saudi Arabia alone could not defend OPEC’s pricing system.

In 1985, the Saudi leaders were in a difficult domestic political situation, because they were no longer able to maintain Saudi Arabia as a rentier state. Until it gave up its oil policy as a swing producer in September 1985, production had declined to 2.2 million

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[106] The Financial Times Limited, "The Need for Cheaper Oil," Section I; 12.

[107] Petroleum & Energy Intelligence Weekly, "Slump in Demand for OPEC Oil Seen Continuing into 1986," *Petroleum Intelligence Weekly* XXIV, no. 21 (May 27, 1985): 1-2.

b/d in August since February.[108] By late summer 1985, monthly oil revenues were under $1 billion, barely 10% of peak levels in 1981. By the summer of 1985, Saudi Arabia had absorbed 60% of OPEC's cutback since the late 1970s.[109] With a huge reduction in oil production and in its oil revenues, it posted the second-largest deficit in the world in 1985, right behind the United States.[110] As mentioned in Chapter IV, Saudi leaders regarded a rentier state as a necessary condition for the consolidation for the maintenance of their political power. In this regard, the state continued to provide poorer Saudis with free medical care and education, social security and a substantial range of social services, and interest-free loans for marriage and vocational training, even in the recession.[111] In al-Yousef's interview with Hisham Nazer, the former Saudi Minister of Central Planning, in charge of the formulation and implementation of the Five-Year Plans, he said, "Saudi Arabia did not suffer in the first two years, because it used its financial surpluses to cover the budget deficit. However, when demand for its oil continued to decline, as well as revenues, Saudi Arabia had to abandon the swing producer role."[112] As Nazer mentioned, it became difficult for the government to maintain its generous social welfare programs with deteriorating oil revenue in 1985. The government's guaranteed price for purchases of wheat was lowered, electricity and water prices were increased, and fringe benefits for

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[108] "PIW's Estimated Tally for 1985," 10.

[109] Cable, American Embassy in Riyadh to Secretary of State, June 25, 1986, Department of State.

[110] Nakhleh, *The Gulf Cooperation Council*, 15.

[111] Cable, American Embassy in Riyadh to Secretary of State, American Consul in Dhahran and American Consul in Jeddah, March 8, 1986, Department of State.

[112] Al-Yousef, "The Role of Saudi Arabia," 67.

civil servants were cut. As many government-sponsored projects were canceled or simply delayed, the construction industry also suffered severely from the recession.[113] As Saudi government's distributive function was considerably reduced, the life of the population as a whole, whose main source of income was rent-seeking, became affected by the government's austerity. With the disastrous economic outcome of Saudi oil policy during the first half of 1980s, the negative effect of the country's segmented bureaucratic system and the increasing opposition of other ministers to Yamani's oil policy made it more difficult for Yamani to drive a coherent and consistent policy.

With the gloomy prospects for the future of the oil market, all these internal and external developments finally led Saudi Arabia to decide to surrender its role as a swing producer by the summer of 1985. It threatened other OPEC members at the June 1985 meeting in Ta'if that Saudi Arabia would act unless they stopped overproducing their oil at discount prices, but this warning had no effect. Saudi Arabia also failed to persuade the American government to press the four former Aramco partners into increasing their liftings of Saudi oil in the summer of 1985. As a result, its recorded oil revenue in July 1985 fell below $1 billion for the first time in years, and Aramco was barely producing enough gas to supply Saudi Arabia's new petrochemical complex. To increase oil production, which had stayed at disastrously low levels, Yamani approached the Aramco partners, who suggested the use of netback contracts, which could guarantee refiners a positive margin on purchases of Saudi oil and transfer risk from the crude oil customers

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[113] Cable, American Embassy in Riyadh to Secretary of State, June 25, 1986, Department of State.

to the producers.[114] In an interview with the London Arabic weekly *al-Majalla*, Yamani finally confirmed that Saudi Arabia no longer saw itself as the swing producer within OPEC and decided to produce its quota within OPEC's overall 16 million b/d production ceiling. As a result of this decision, Saudi Arabia would produce its full OPEC quota of 4.35 million b/d, which OPEC had assigned in November 1984.[115] It is hard to say exactly when Saudi Arabia began to initiate this new market-share strategy to boost its production. However, it is generally accepted that the new oil policy began some time in September 1985. While it gradually increased output to 4.35 million b/d during the last quarter of 1985 (including September), it had always warned other oil producers, particularly non-OPEC suppliers, that they would face a price war if they did not restrain production. At the Oxford Energy Seminar on September 13, Yamani warned: "If non-OPEC producers do not cooperate with OPEC in stabilizing the market and we in the Organization do not discipline ourselves, then I expect there will be a price war."[116] After failing to gain the cooperation of the non-OPEC countries in stabilizing oil prices, Yamani tried to regain Saudi Arabia's market share by introducing the mechanism of netback pricing, which initiated a price war in 1986.

Although Saudi Arabia gave up its oil policy as a swing producer, it did not seek to destroy OPEC. At the OPEC Conference in December 1985, it succeeded in

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[114] Cable, American Embassy in Riyadh to Secretary of State, June 25, 1986, Department of State.

[115] Middle East Petroleum and Economic Publications, "Saudi Arabia: Yamani Confirms Saudi intention to Produce Quota," *Middle East Economic Survey* XXVIII, no. 43 (August 5, 1985): A1.

[116] "OPEC: Yamani Denies Having Made $15-18/B Price Prediction," *Middle East Economic Survey* XXVIII, no. 50 (September 23, 1985): A3.

engineering a new strategy to increase OPEC's market share. The conference communiqué declared: "Having considered the past and likely future developments in the world oil market and the persistently declining trend of OPEC production, the Conference decided to secure and defend for OPEC a fair share in the world oil market consistent with the necessary income for Member countries' development."[117] With this decision, OPEC increased its output (comparing actual January-August average production of 18.6 million b/d with prewar projected average production of 15.9 million b/d for the same period) by the summer of 1986 with a $50 billion loss in actual revenue compared with potential revenue.[118] However, despite a fall in revenue of 11% in the first half of 1986 compared with the first half of 1985 due to dramatic oil price drop, Saudi Arabia produced close to its quota.[119] According to the American embassy in Riyadh, Saudi Arabia wanted to give OPEC one important lesson: that only renewed, Saudi-inspired discipline could save OPEC via showing that Saudi Arabia would take its "fair share," but no more, even when it was receiving less than its desired revenues.[120]

Because of the disastrous fall in oil prices (to below $10 per a barrel), Saudi Arabia decided to make a temporary cut along with other members of OPEC in the

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[117] OPEC, *Official Resolutions and Press Releases*, 236.

[118] Nordine Ait-Laoussine and John C. Gault, "The 1986 Oil Price War: An Economic Fiasco," *Middle East Economic Survey* Supplement to XXIX, no. 52 (October 6, 1986).

[119] Middle East Petroleum and Economic Publications, "OPEC Production Statistics 1985-1986," ibid. XXIX, no. 47 (September 1, 1986): D1; Petroleum & Energy Intelligence Weekly, "OPEC is Paying a High Price for Market Share Quest," *Petroleum Intelligence Weekly* XXV, no. 30 (July 28, 1986): 4.

[120] Cable, American Embassy in Riyadh to Secretary of State, June 25, 1986, Department of State.

summer of 1986. With the increase in OPEC's output, the crude oil netback value of Arabian Light 34° for refiners in July recorded $9.64/barrel on the US Gulf coast and $8.97/barrel in Rotterdam.[121] The huge reduction in revenue and the consequent difficulties in securing the necessary financing for 1986 led King Fahd to decide on March 9, 1986 to withhold the publication of a controversial 1986 austerity budget for five months.[122] In this emergency situation, Saudi Arabia reached an agreement with the other members of OPEC at the OPEC Conference in August 1986 to cut production temporarily for September and October by abiding by their quotas. The exception was Iraq, on the basis of the ceiling of 16 million b/d, which had been decided in October 1984.[123] This decision led Saudi Arabia to cut its production to 4.5 million b/d in September (its production quota was 4.34 million b/d) from 5.7 million b/d in July, while allowing OPEC members to reap a 19% increase in revenue in September compared with July, with a price 50% higher than in July.[124] After this decision in August, oil prices

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[121] Petroleum & Energy Intelligence Weekly, "Refiners Weather the Summer Price Tempest: Monthly Supplement," *Petroleum Intelligence Weekly* XXV, no. 30 (July 28, 1986): 4.

[122] Briefing Memorandum, Frederick N. Khedouri to Vice President, March 28, 1986, folder "The Vice President's Trip to the Persian Gulf and Arabian Peninsula, April 3-12, 1986 [Briefing Book] (2)," box 91688, Near East and South Asia Affairs Directorate, NSC Records, Ronald Reagan Library.

[123] OPEC, *Official Resolutions and Press Releases*, 244-45.

[124] Petroleum & Energy Intelligence Weekly, "OPEC Cutbacks Paying off in Higher Oil Revenues," *Petroleum Intelligence Weekly* XXV, no. 40 (October 6, 1986): 5; It is uncertain why Saudi Arabia's production in July increased in comparison with the production level of around 4.5 million b/d in the previous half of 1986. Disappointing oil revenues in the first half of 1986 caused increasing dissatisfaction within the royal family. While Fahd was having difficulty in finalizing the 1986 budget, it is very likely that he would have asked Yamani to increase oil production as a last resort to enable him

gradually moved upwards. The crude oil netback value of Arabian Light 34° for refiners in the US Gulf Coast climbed to $11.59/barrel in August, $11.84/barrel in September and $12.52/barrel in October.[125] Although the decision to cut OPEC members' production was temporary, it was the first time that Saudi Arabia had cooperated with other OPEC members to defend oil prices since it had given up its role as a swing producer. However, at this time, the government's decision was taken not to defend a certain specific level of oil prices, but in order to prevent oil prices from collapsing without any specific target price. In these circumstances, the Saudis decided to reduce their production to the level of their deemed quota.

The partial success of OPEC in persuading non-OPEC suppliers to support its efforts to improve and stabilize oil prices, as well as increase in revenue, encouraged Saudi Arabia, presumably King Fahd, to aim for a certain target level of oil prices. After the August decision of OPEC members to cut their production, *PIW* estimated that Saudi Arabia's oil revenues increased by 9% in September compared with July. However, the American embassy in Riyadh estimated that revenues doubled between July and September.[126] Furthermore, some non-OPEC countries began to cut their production voluntarily to help OPEC's efforts to stabilize oil prices. On August 21, after a four-day visit to Moscow, the Iranian Oil Minister, Gholamreza Aghazadeh, stated that the Soviet

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to attain his own financial goals. However, this production boost seems to have accelerated the price collapse during the summer of 1986.

[125] "Weakening Markets Look to OPEC for Direction: Monthly Supplement," *Petroleum Intelligence Weekly* XXV, no. 39 (September 29, 1986): 4; "Refiner Strategy Key to Post-Geneva Prices: Monthly Supplement," *Petroleum Intelligence Weekly* XXV, no. 43 (October 27, 1986): 4.

[126] Cable, American Embassy in Riyadh to Secretary of State, November 30, 1986, Department of State.

Union had told Iran that it was ready to cut its exports to Western Europe by 100,000 b/d in September and October. In an interview with a business publication in Oslo on August 21, the Norwegian Oil Minister, Mr. Arne Oeien, hinted broadly that the United States had been doing its best to persuade Norway not to cooperate with OPEC in any production control agreement. At the same time, the Norwegian government said that it would announce its decision on possible cooperation with OPEC by September 1.[127] As it promised, it announced plans in September to cut its oil exports by 10% in November and December.[128] Although Saudi Arabia failed to receive cooperation from the UK, and the support of the Soviet Union and Norway for OPEC did not bring about any particularly desirable results, the positive gestures from those non-OPEC suppliers and the increase in Saudi oil revenues encouraged King Fahd to make efforts to achieve an agreement on prices of between $17 and $19 per barrel with the GCC members of OPEC at a meeting of GCC Foreign and Oil Ministers in Abha on August 26-27.[129]

While the oil market was in turmoil during 1986, there was an evident conflict of opinion between King Fahd and Yamani, and the deterioration of their relationship culminated in October 1986. At the OPEC Conference on October 6-22, 1986, in Geneva, Saudi Arabia agreed to extend the interim and temporary production cut among OPEC

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[127] Middle East Petroleum and Economic Publications, "OPEC and Oil Prices: Norwegian Oil Minister Hints US is Urging Norway Not to Cooperate with OPEC," *Middle East Economic Survey* XXIX, no. 46 (August 25, 1986): A3-A4.

[128] "Norway Will Cut Exports by 10%," *Middle East Economic Survey* XXIX, no. 49 (September 15, 1986): 1-2; The plan was originally intended to commence on October 1, but it was delayed until November 1, because of various technical problems.

[129] "GCC States Reaffirm Commitment to $17-19/B Price Target," *Middle East Economic Survey* XXIX, no. 47 (September 1, 1986): A2-A3.

members with some minor adjustments through November and December 1986.[130] During the meeting, Fahd wanted production increases and higher oil prices, asking Yamani several times to increase Saudi Arabia's quota, asserting that oil should be sold at $18. Yamani could not persuade the king that supply and demand curves did not work in the way that he wanted. After seven days, on October 29, while at a friend's house, Yamani heard on the television evening news that he had been fired.[131] The deterioration of the relationship between King Fahd and Yamani in 1986 had long been visible. During Vice President Bush's visit to Saudi Arabia in the spring of 1986, Fahd plainly showed his dislike of Yamani, embarrassing both the Americans and the Saudis.[132] On September 5, 1986, Yamani was invited to speak at Harvard University's 350th Anniversary celebrations. His speech was followed by a question and answer session, during which he was asked how oil policy was made in Saudi Arabia? He replied, "We play it by ear."[133] Tired of persuading King Fahd and other royal family members to stick to an oil policy based on long-term economic interests, Yamani had dared to criticize the improvisation "method" in policymaking in Saudi Arabia.

There were several rumors regarding Yamani's firing. Some said that Yamani had embarrassed the royal family not only by failing to pursue Fahd's orders in Geneva,

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[130] OPEC, *Official Resolutions and Press Releases*, 250; Even after OPEC's agreement in August, it was still suffering from over production among members, particularly the UAE and Venezuela. See Middle East Petroleum and Economic Publications, "OPEC Production Agreement Still Faces Observance Problems," *Middle East Economic Survey* XXIX, no. 51 (September 29, 1986): A1-A2.

[131] Robinson, *Yamani*, 32.

[132] For the details of this event, see ibid., 182-84.

[133] Yergin, *The Prize*, 762.

but also by criticizing economically illogical instructions from Fahd. Such behavior on Yamani's part raised strong antipathy towards him from the Saudi royals. It was also said that King Fahd simply did not like Yamani.[134] It has been also suggested that Yamani's dismissal from his post as Saudi Oil Minister was orchestrated by Iran; in an attempt to compromise with Iran, Saudi Arabia needed Yamani as a victim.[135]

According to the analysis of the American embassy in Riyadh, Yamani's dismissal was the outcome of several factors: rivalries within the Saudi Arabian government, royal annoyance at Yamani's performance at the October OPEC ministerial conference, opposition to his market-share strategy, and so on.[136] One thing that is clear is that the relationship between King Fahd and Yamani had deteriorated at least partly because of the devastating domestic economic consequences of Yamani's oil policy, and since the summer of 1985, Saudi Arabia no longer wished to sacrifice its economy to enable it to continue is role as a price setter.

After Yamani was fired in October 1986, Saudi Arabia abandoned Arabian Light 34°'s position as a single market crude within OPEC. At the OPEC Conference on December 11-20, 1986, the new oil minister, Hisham Nazer agreed to a fixed pricing system at a level of $18 per barrel as OPEC's reference price. To achieve this goal, OPEC members decided to cut production in accordance with their own quotas, and applied a ceiling of 15.8 million b/d for the first and second quarters of 1987, a ceiling of 16.6 million b/d for the third quarter and a ceiling of 18.3 million b/d for the fourth

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[134] Ibid., 763.

[135] Cable, American Embassy in Riyadh to Secretary of State, November 30, 1986, Department of State.

[136] Ibid.

quarter. To return to the former fixed pricing system, they also decided to eliminate netback or other market-related pricing in effect from February 1, 1987. One of the most important agreements at the December Conference in Geneva was that OPEC decided to use a basket of crudes (six from OPEC and one from a non-OPEC member, Mexico) instead of using a single Marker Crude, Arabian Light 34°. The main reason was to avoid the drawbacks of the previous fixed price system, which put huge swing production pressure on Saudi Arabia.[137] After this decision, Saudi Arabia played only a limited role as swing producer in comparison with the first half of the 1980s. While another five OPEC members shared the burden of defending OPEC's pricing system, Saudi Arabia could at least secure its allocated quota, regardless of market conditions.

However, fixed pricing based on a quota system did not work during 1987, and Saudi Arabia finally adopted the market-related formula pricing[138] and the quota system within OPEC, which still prevails today. However, it failed again to achieve price and production discipline among OPEC members in 1987. While OPEC's production exceeded its ceiling with member countries' oversupply, oil prices fell below the target price of $18 per barrel. Cheating among members was widespread. By June 1987, Saudi Arabia was the only country abiding by OPEC's official price and quotas. As a result, in

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[137] Ian Seymour, "OPEC Aims to Elliminate All Netback Deals by 1 February," *Middle East Economic Survey* XXX, no. 11/12 (December 22/29, 1986): A1-A4.

[138] According to Fattouh, "Saudi Arabia now relies on the IPE Brent Weighted Average (BWAVE). The BWAVE is the weighted average of all future price quotations that arise for a given contract of the futures exchange (IPE) during a trading day. The weights are the shares of the relevant volume of transactions on that day. Specifically, this change places the future market, which is a market for financial contracts, at the heart of the current pricing system." See Bassam Fattouh, "OPEC Pricing Power: The Need for a New Perspective," *WPM* 31 (March 2007), http://www.oxfordenergy.org/wpcms/wp-content/uploads/2010/11/WPM31-OPECPricingPowerTheNeedForANewPerspective-BassamFattouh-2007.pdf.

June 1987, Saudi Arabia was resigned to acting again as a swing producer to defend the official price of $18 per barrel and began to adopt formula pricing.[139] As a result, Yamani's long-term strategy for Saudi Arabia to be the price setter through OPEC by taking the role of swing producer was completely abolished. Saudi Arabia's long history of attempts to control world oil prices eventually succumbed to the pressure of market forces.

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[139] Al-Yousef, "The Role of Saudi Arabia," 72; Petroleum & Energy Intelligence Weekly, "Future Saudi Role as Swing Producer a Worry in Vienna," *Petroleum Intelligence Weekly* XXVI, no. 26 (June 29, 1987): 1-2.

CHAPTER X

CONCLUSION

Since the early twentieth century, the development of the oil industry has brought about innovation in all aspects of human life, and has became a crucial factor in determining the condition of the world economy and world politics. Because of the strategic importance of this valuable natural resource, every country has paid close attention both to the world oil industry and to the oil producing countries. In the political arena, the superpowers tried to win over the oil producing countries, particularly in the Middle East, to their side during the Cold War. Both the United States and the Soviet Union well knew that their supremacy over the other could not be guaranteed without acquiring the support of these oil-producing countries. On the other hand, the Middle Eastern oil producers tried to maximize their political and economic bargaining power by capitalizing on their oil. In oil history, one of most interesting events was the emergence of OPEC and its takeover of oil prices during the 1970s. However, without Saudi Arabia joining OPEC, and the 1973-74 Arab oil embargo, the possibility of the emergence of a second oil price regime in oil history, which allowed OPEC to control world oil prices, came into question. Regarding the importance of Saudi oil in the world economy, House noted as follow:

> Because Saudi Arabia produces fully one of every four barrels of oil sold on the world market, what happens in this most veiled of Arab societies will affect not only the future of 19 million Saudis but also the stability and prosperity of the global economy, and it will touch the lives of every citizen in the world.[1]

The decisions of Saudi policy makers not only affect the lives of their own people, but also make topographical changes in the politics and economics of world oil.

In spite of the importance of the Saudi oil industry in the world economy and world politics, it is really hard to understand Saudi oil policy without a comprehensive study, because Saudi oil policy has become intermingled with political and economic interests and numerous previous studies based on different perspectives with their own plausible explanatory tools have often provided readers with narrow and partial information on Saudi oil policy. Some commentators, focusing on economic explanations, usually indulged in developing economic models. These studies have provided us with theoretical economic tools to analyze how Saudi Arabia has tried to maximize its valuable oil resources in the long term. In the process of generalizing about Saudi oil policy based on their own economic theories, however, they have had a tendency to ignore some political factors behind Saudi oil policy, which have sometimes made it deviate from their theories. Other authors, giving a lot of weight to political explanations, have explained Saudi oil policy well, particularly when they have related it to specific political events. However, they have usually missed the general economic logic of Saudi oil policy and made the behavior of Saudi decision-makers seem arbitrary and impromptu in accordance with the country's politics. As a result, previous studies of Saudi oil policy, which have generally focused on a single explanatory factor, have

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[1] Karen Elliott House, *On Saudi Arabia: Its People, Past, Religion, Fault Lines and Future* (New York: Vintage Books, 2012), 3.

generally failed to tell the whole story.

Although there have been some attempts to understand Saudi oil policy through more comprehensive studies, their explanations have generally omitted any deep economic analysis of Saudi oil policy and have usually focused on the period of the oil boom. For example, Quant tried to understand Saudi oil policy on the basis of the country's long-term economic interests in keeping the demand for oil high, while admitting that the two exceptional cases of 1973 and the first half of 1979 were politically motivated. Although it is necessary to analyze how Saudi Arabia has tried to maximize the value of its oil wealth to arrive at an understanding of the economic logic of its oil policy, he took for granted that the long-term goal of Saudi oil policy was embedded in maintaining a high demand for oil. Still, how does this interpretation of Saudi Arabia's long-term economic interests explain Yamani's appeals to the consuming countries to reduce consumption and to develop alternative energy sources during the boom period? In addition, how can we understand why Saudi Arabia tried to defend relatively high oil prices in the first half of the 1980s, when the world oil market was experiencing falling demand?

Golub, on the other hand, considered that the long-term economic interests of Saudi oil policy were simply embedded in price maintenance. Without putting forward any economic theoretical explanation of Saudi oil policy, he reached the conclusion that political considerations are the primary motivation for Saudi oil policy. If he is correct, why did Saudi Arabia try to defend relatively high oil prices at the expense of its economy in the first half of the 1980s? In this period, Saudi Arabia needed military assistance from the United States, which was pursuing market-oriented oil prices. At the same time, this oil policy also necessitated making sacrifices in the Saudi economy, which brought increasing internal dissatisfaction.

Furthermore, many contradictory and deceptive comments on Saudi oil policy by senior Saudi policy makers make explanations of their oil policy farfetched, and easily confuse those investigating their behavior. When Saudi policy-makers were trying to obtain political rewards from the West, they tried to make it seem that they were pursuing moderate oil prices to create a healthy world economy. Such statements have led researchers to focus on the theme of price moderation in Saudi oil policy. According to their explanations, the long-term economic interests of Saudi oil policy are strongly embedded in price moderation, and researchers point to this policy in the late 1970s and the early 1980s as crucial evidence for their argument. They argue that Saudi Arabia tried to stabilize the oil market and to create moderate oil prices by increasing its oil production to fill the supply shortage caused by the Iranian Revolution and the Iran-Iraq War. However, they could not explain why it would have agreed with the other OPEC members on price increases while simultaneously acting contrary to these agreements. On the other hand, when Saudi policy makers raised oil prices, they explained their behavior as a reaction to overuse on part of the consuming countries. For some authors, this justification was only hypocrisy on the part of Saudi Arabia, masking its real intentions, which were to acquire as much oil revenue as possible. Therefore, such authors, focusing on Saudi Arabia's agreements with other OPEC members to raise oil prices, described Saudi oil decision-makers as greedy profit seekers. However, they could not explain why Saudi Arabia continuously tried to stabilize the world oil market by increasing its production. Without Saudi Arabia's production boost in the late 1970s and the early 1980s, oil prices would have risen even further. Although there is historically important but contradictory evidence, many commentators have tended to focus selectively on arbitrary and fragmentary historical facts that suit their argument and have used these “facts” to reconstruct the story of Saudi oil policy. In this reasoning, the characterization of Saudi Arabia as a swing producer in the first half of the 1980s still leaves some questions unresolved.

To understand the behavior of Saudi decision makers, we first have to understand the way in which the Āl Sa‘ud has tried to consolidate its political power, which it has done by employing three major political strategies. First, the Āl Sa‘ud achieved its political legitimacy by both supporting and gaining support from Wahhabism domestically and internationally. Having the two holiest Islamic cities on its territory, Saudi Arabia naturally became the center of the Muslim world, and the partnership between the Āl Sa‘ud and the Wahhabi movement has given it political legitimacy. The Wahhabi movement is the prime source of legitimacy for the Saudi regime. Secondly, the alliance with the West, particularly the United States, not only facilitated the emergence of the Kingdom of Saudi Arabia as a major mover in world politics in the twentieth century, but also provided it with economic benefits and protection from external threats. As Saudi Arabia has political and economic interests broadly similar to those of the West, this newly emerged political entity was able to survive even in the twenty-first century, although many Middle Eastern regimes have been overthrown or otherwise collapsed. Finally, the Saudi ruling family has attempted to attract the political loyalty of the population by transforming Saudi Arabia into a rentier state. As Saudi leaders believe that widely applied welfare programs and not taxing the population can consolidate their political power, they try to keep providing their people with these benefits. Most Saudi leaders believe that their political power can be guaranteed as long as they succeed in securing these goals.

With the dynamic development of the Saudi oil industry in the twentieth century, it is necessary to see how the government has tried to maximize its oil wealth in the long-term without sacrificing its long-term political interests. Various economic theories explain Saudi oil policy based on the concept of long-term wealth maximization. In contrast with other Middle Eastern countries, Saudi Arabia had huge oil reserves with high production capacity, while its population was relatively small in the 1970s and 1980s, and therefore it had no acute financial needs, unlike Iran and Iraq. These characteristics of the Saudi oil industry and the economy led the country's leaders to take on the role of swing producer within OPEC, in order to set "desirable" prices on the world oil market. Except for particular oil policies put into place during political emergencies, Saudi Arabia played the role of an aggressive swing producer between the late 1970s and the first half of the 1980s, in order to secure its long-term political interests as well as its long-term economic interests.

The explanation of the dominant producer model fit well the behavior of Saudi decision-makers during this period. According to this model, Saudi Arabia sets its desirable oil prices, which can maximize the value of its oil wealth in the long-term, and other oil producers produce as much as they can under the conditions of specific oil prices set by Saudi Arabia. After that, it makes up the remaining demand for oil. The major purpose of this model is to maintain a high level of demand, [2] as well as keeping prices at a level that would discourage the development of alternative energy sources and the expansion of production on the part of fringe members. To achieve these two goals, Saudi Arabia needed to be the primary price setter in the world oil market through the skillful manipulation of OPEC. Otherwise, it would be unable to maximize the value of its oil resources in the long-term and its long-term political interests would be seriously threatened.

Since the Doha Conference in December 1976, Saudi Arabia generally tried to maximize the long-term value of its oil by engineering moderate oil prices on the market until early 1979. During this period, however, it had difficulties reaching an agreement on oil prices with other OPEC members, which it did manage to achieve in July 1977. Although there was another disagreement on oil prices within OPEC in December 1977, it was manageable, because most members of OPEC, including four of the Gulf sheikdoms and Iran, joined Saudi Arabia. All these events within OPEC during the second half of the 1970s derived mainly from Saudi Arabia's strong desire to apply relatively moderate oil prices vis-à-vis the OPEC hawks.

In addition to the bitter experience of disagreement on oil prices with other OPEC members, which exposed Saudi Arabia to increasing pressure to reduce oil production and to the increasing possibility of domestic discontent with its policies, the widely spread discourse of future supply shortages in the oil market made Yamani favor a long-term strategy for OPEC that would avoid any repetition of the difficulty in

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[2] Theoretically, a dominant producer tries to maintain high demand for oil to maximize the value of its oil in the long-term. However, in reality, it wants to keep oil demand at a manageably high level without challenging the oil prices that it wants.

achieving a unified oil price within OPEC. In particular, future supply shortages might give market forces more room to manipulate oil prices, and would certainly allow market forces to control these prices. As Yamani considered that such developments would ultimately undermine Saudi Arabia's long-term economic and political interests, he urged the oil-consuming countries to reduce consumption and to commit to the development of alternative energy sources. Hence, he justified the oil price rise in December 1978, which was designed to avoid this situation; although, the decision was also substantially influenced by increasing pressures from the neighboring Arab countries in reaction to the Camp David Accords of September 1978. However, it was clear that Yamani had already envisaged an oil price rise in the near future, and that political events in the Middle East simply advanced the date.

In the first half of 1979, Saudi Arabia's oil policy clearly deviated from its long-term economic interests. The political crisis brought about by events in the Middle East, such as the increasing criticism of the Camp David Accords on the part of most Arab countries, the Iranian Islamic Revolution and the unity talks between Iraq and Syria, put a lot of pressure on Saudi Arabia to reduce its production, and it was obliged to give in to some of these pressures. However, Saudi Arabia's decision to cut back production caused an already tight market situation to deteriorate, and oil prices began to skyrocket, allowing market forces to dictate prices. Furthermore, the high possibility of supply shortages in this period encouraged the consuming countries to resort to panic buying and stockpiling. In the tight market conditions of early 1979, the pressures on Saudi Arabia to reduce oil production usually came from outside, particularly from members of OPEC, because of their desire to achieve higher oil prices and high oil revenues. Widespread premiums, differentials, as well as surcharges on OPEC crudes encouraged most OPEC members to leave the organization's pricing system during this period. Higher oil prices mainly caused by a politically motivated Saudi oil policy early in 1979 began to undermine the fragile price unity of OPEC, making it more difficult for Saudi Arabia to set oil prices until the early 1980s.

In the middle of 1979, when the political crises had abated somewhat, Saudi Arabia took steps to restore its position as a price setter in the world oil market. To achieve this goal, it first needed to reunify OPEC's oil prices. In attempting to achieve this, Saudi Arabia first tried to expand its participation in oil exports by increasing its direct crude oil sales under new state-to-state deals. This contributed to the reduction of oil transactions on the spot market. As a next step, it gradually increased its official Marker Crude prices to limit the oil transactions of other OPEC members by reducing the gap between the official prices of other OPEC members and the spot price. At the same time, the Saudis expected raising their own prices would prevent a future crisis on the oil market by discouraging intemperate oil consumption and also by encouraging the development of alternative energy sources and the exploration of high cost oil fields. Finally, the Saudis increased their output to stabilize the world oil market, in an attempt to prevent market forces from manipulating oil prices upwards. All these actions of Saudi oil decision makers in the late 1970s and the early 1980s have confused some researchers, and made any analysis of Saudi oil policy difficult, because Saudi Arabia pursued seemingly contradictory policies not only by increasing its oil production but also by agreeing with other OPEC members to raise prices. Furthermore, the diplomatic rhetoric of Saudi policy makers, who were aiming to acquire advanced arms from the US in the early 1980s, misled researchers into thinking that their policies were not related to the state's long-term economic interests. However, when we remove all this diplomatic rhetoric, which did not actually affect an oil policy based on long-term economic interests, we can reach the conclusion that the behavior of policy makers was tactfully designed to achieve Saudi Arabia's long-term economic interests by restoring its position as a price setter.

Although the Saudis succeed in achieving price unity with the other OPEC members on October 1981, they failed to identify the coming structural changes in the world oil market, which would seriously threaten the solidarity of OPEC, and also imposed a huge burden on the Saudi economy mainly due to its maintaining its role as a swing producer during the first half of the 1980s. The high oil prices mainly engineered by the 1973-74 Arab oil embargo and the 1979 oil crisis, necessarily brought gradual changes to the world oil market, and oil demand had begun to decline since the late 1970s. This basic structural change was not a big problem for OPEC members, because their generally positive experiences of the oil crisis of 1979 made them imagine that consumers would be ready to pay high prices whatever the costs and that this phenomenon would be perpetuated. However, the depressed demand for oil during the 1980s took a long time to recover, and OPEC was obliged to lower its official oil prices in March 1983 for the first time in its history. OPEC members were the victims of declining oil demand in a slack market, which threatened the very existence of the organization. In addition, high oil prices and the various nationalizations of the oil industry in the Middle East encouraged major oil companies to embark on oil exploration in expensive and high-risk areas such as the North Sea. Although the production of non-

OPEC suppliers gradually increased in the late 1970s and the early 1980s, they were still price takers in the world oil market and had little influence over prices. Even Yamani did not seem to understand how increases in non-OPEC production would influence the whole structure of OPEC's pricing system, continuously asking oil companies to accelerate oil exploration in non-OPEC areas in order to prevent future energy crises. However, non-OPEC suppliers, particularly the North Sea producers, became price leaders in early June 1981, and continued to challenge OPEC's pricing system throughout the 1980s. Furthermore, the practice of stockpiling increased to the extent that it could distort the world oil market as a "hidden consumer" or a "hidden producer" during the 1980s. Stockpiling and destocking in the oil consuming countries as a defensive mechanism against possible shortfalls in oil supply had already paid off on the outbreak of the Iran-Iraq War. More importantly, market forces began to penetrate the world oil market with the emergence of neoliberal economic practices, gradually undermining Saudi Arabia's ability to control oil prices through OPEC.

These changes combined to create a slack market in the early 1980s, and Saudi Arabia was obliged to take the role of swing producer within OPEC to defend its pricing system. In particular, it became the only OPEC member to support the whole structure of OPEC's pricing, because two particularly influential members, Iran and Iraq, were fighting each other during this period and OPEC could not expect any help from either of them. Considering the political context in the Middle East, there were no external political factors that seriously compelled Saudi Arabia to take the role of swing producer in this period. Although the market situation in this period imposed enormous burdens on the Saudi economy in the short- and midterm because of its production cutbacks and the consequent decrease in oil revenue, Saudi Arabia continued its oil policy as a swing producer to secure its long-term economic interests, which also satisfied its long-term political interests.

The dominant producer model, which is a good explanation of Saudi Arabia's oil policy as a swing producer, argues that the dominant producer, in this case the government of Saudi Arabia, should maintain world oil prices at a level which would discourage any expansion on the part of "fringe members," namely the non-OPEC suppliers. Saudi Arabia tried to defend relatively high oil prices, which still gave non-OPEC producers incentives to increase their output during the first half of the 1980s. It seems that Saudi Arabia was not satisfied with the economic logic of the dominant producer model to maximize the value of its oil in the long-term. In this slack market situation, when the market share of non-OPEC producers was increasing continuously and rapidly at Saudi Arabia's expense, it should perhaps have tried to recover its declining market share by lowering its prices even further. Until its market share fell to its unacceptable levels in the middle of 1985, however, it did its best to defend OPEC's relatively high oil prices.

To understand why Saudi Arabia did not follow the basic economic logic of the dominant producer model in detail by pursuing relatively higher oil prices at the expense of its own economy, we should remember that in the first half of the 1980s the world oil market was facing the real possibility of the collapse of both world prices and of OPEC. In the real world during this period, the story of Saudi oil policy was somewhat different from the mechanism of the dominant producer economic model. As Saudi Arabia relied heavily on OPEC's pricing system to control world oil prices, it could not set oil prices independently at levels that would be unacceptable to other OPEC members. In addition, most OPEC countries were suffering financial deficits, caused mainly by decreasing oil production and lower prices. Given the spread of neoliberal economic practices in the world economy, encouraged by the Reagan administration, and the increasing influence of the uncontrolled (and uncontrollable) non-OPEC suppliers over oil prices, it was clear that lowering Saudi Arabia's official prices in a slack market would accelerate the breakaway from OPEC of the most financially disadvantaged members of the organization and would lead them to participate in unlimited price competition with non-OPEC suppliers, which would bring down oil prices even further. All these developments would give market forces more opportunity to cause fluctuations in oil prices and certainly trigger a price collapse on the world market. At this point, the continuing existence of OPEC could not be guaranteed. The *New York Times* described this urgent situation early in 1983: "The recent collapse of OPEC prices proves there is no cartel capable of manipulating supplies. Nor could Saudi Arabia, the largest of the exporters, reduce deliveries sufficiently to create a world crisis."[3] During this period, Saudi Arabia was not in a position to manipulate oil prices to desirable levels on the world oil market, but had to prevent both oil prices and OPEC from collapse by defending the OPEC pricing system. The Saudi leaders knew that if oil prices began to collapse, it would be difficult for OPEC to avoid a tragic fate, and Saudi Arabia's long-term economic and political interests would be endangered.

In addition to the high possibility of the collapse both of oil prices and of OPEC, Yamani's view of the future oil market contributed to Saudi Arabia's active defense of

[3] New York Times Company, "Penny Wise, Barrel Foolish," *New York Times* March 7, 1983, A14.

relatively high oil prices. His unpleasant experience of volatile oil prices in the 1970s and the early 1980s with the increasing influences of market forces in the world market naturally encouraged him to be interested in avoiding a bitter oil crisis that would seriously threaten Saudi Arabia's long-term economic and political interests. The founder and principal apologist for a long-term strategy for OPEC, Yamani envisaged that a price of around $30 per barrel at that time could guide the world oil market to a new era of stability, as well as securing Saudi Arabia's long-term economic and political interests. Yamani's inaccurate anticipation that the oil market would recover in the near future and that Saudi oil policy as a swing producer would eventually reward Saudi Arabia with economic and political prosperity, was the main reason why it defended OPEC's artificially high oil prices at whatever cost in the middle of 1985.

It is important to note that all these decisions of Saudi Arabia originated largely from Yamani's negative view of market forces. He believed strongly that the price of oil, the most valuable natural resource, should not be controlled by market forces, whose prime purpose is to maximize private profit, but should be managed by OPEC for the public good. One of main reasons why he was afraid of price collapse was the fact that this would provide market forces a golden opportunity to control oil prices at the expense of OPEC. Furthermore, he believed that without a long-term strategy for OPEC, the world oil market would be continuously exposed to an energy crisis that would ultimately allow market forces to control oil prices. All these considerations and his visions of the future of the oil market led Yamani to continue to advocate for Saudi Arabia to act as a swing producer for a relatively long-time. There seems to have been a general agreement on this course of action within the ruling family until the middle of 1985, when economic difficulties began to challenge the political stability of the Saudi regime.

For the success of Saudi Arabia's oil policy as a swing producer under slack market conditions, price and production discipline within OPEC and the cooperation of non-OPEC suppliers were necessary. By early 1985, however, Saudi Arabia had largely failed to secure these two important conditions and its production was falling below levels that the Saudi public could accept in the summer of 1985. The deteriorating economic situation meant that Saudi Arabia could not function as a rentier state any more, and there was growing internal dissatisfaction expressed on the part of both ordinary Saudis and members of the royal family with what was a politically and economically painful policy. Yamani's promotion of Saudi Arabia's role as a swing producer for three years not only devastated the Saudi economy, but also increased the vulnerability of the regime. After his failure to secure cooperation from both OPEC and non-OPEC producers, Saudi Arabia lost any capacity to control the world oil market and could not push its oil policy through any more.

Although Saudi Arabia finally gave up its role as a swing producer by the summer of 1985 and began to take steps to recover its lost market share, it could not leave OPEC to collapse, because its long-term economic and political interests were strongly embedded in the existence of the organization. As Saudi Arabia precariously maintained its production around its quota during the first half of 1986, it tried to prevent the breakdown of OPEC. It was highly possible that Saudi Arabia was pursuing its own price and production discipline within OPEC during this period. Furthermore, the Saudis also expected a degree of cooperation from the non-OPEC producers. In the face of the price collapse during the summer of 1986, OPEC members reached several agreements to save the organization, and also received some cooperation from non-OPEC suppliers in the second half of 1986. In the process, Saudi Arabia gave up the exclusive position of Arabian Light 34° as OPEC's Marker Crude to relieve its huge swing production burden. Instead, OPEC accepted a basket of seven crudes including Arabian Light 34°. This meant that Saudi Arabia still tried to set oil prices through OPEC, although its role was considerably reduced.

However, the efforts of OPEC members to recover their dominant control of oil prices could not reverse the flooding of neoliberal economic practices into the oil market. Except for Saudi Arabia, OPEC members still relied on market-related prices to increase their production, and this was also true of the non-OPEC countries. During the first half of 1987, the oil producing countries' old habit of overproduction and giving discounts on their crudes in a slack market made most of Saudi Arabia's efforts to set prices a vain attempt. When Saudi Arabia adopted formula pricing in June 1987, it finally gave up its strategy to set oil prices at an "economically desirable" level through the manipulation of OPEC. The curtain thus fell on the second price regime controlled by OPEC.

From an analysis of Saudi oil policy in the second half of the 1970s and the first half of the 1980s, my dissertation concludes that Saudi Arabia clearly tried to set desirable oil prices by playing the role of swing producer within OPEC. This basic strategy would not only maximize the economic value of Saudi Arabia's oil in the long-term, but would also contribute to the consolidation of the political power of the Saudi royal family. In terms of setting oil prices, it has been generally accepted that moderate oil prices are theoretically desirable for Saudi Arabia, since they can generally satisfy its long-term economic and political interests. However, because of the vague concept of "moderate oil prices," it is difficult to give an entirely convincing explanation for Saudi Arabia's role as a swing producer in the first half of the 1980s. For example, the price that Saudi Arabia tried to defend in this period was higher in real terms than the average oil price of the second half of the 1970s, and this could hardly be regarded as "moderate." Without a clear redefinition of "moderate oil prices" in the context of the world oil market, it is hard to find any consistent patterns for the behavior of Saudi decision-makers. In my dissertation, I understand the notion of "moderate oil prices" as prices without the huge fluctuations that would encourage market forces to manipulate them. As Saudi officials, particularly Yamani, regarded market forces as the major threat to Saudi Arabia's long-term economic and political interests, undermining its position as a price maker, they tried to set oil prices in a direction that would stabilize the world market. This would give market forces little room to disturb oil prices.

With a new definition of moderate oil prices, this dissertation attempts to understand the logical patterns of Saudi oil policy in different market situations. In a tight market, when long-term economic interests have priority over any short-term political urgency, Saudi policy makers have generally achieved moderate prices by increasing their own oil production. In this situation, moderate oil prices meant preventing higher oil prices. To achieve their aims, the Saudis needed to secure price unity within OPEC, as happened in late 1979 and the early 1980s. However, when the Saudi regime became exposed to immediate political danger from external threats, it feels compelled to cut its production, which results in higher oil prices and revenues. This economically illogical oil policy sometimes brings about skyrocketing oil prices, which certainly threaten Saudi Arabia's long-term economic and political interests because of the considerably increasing influence of market forces over oil prices. The story of Saudi oil policy in the first half of 1979 is such a case. Therefore, as soon the political situation become more manageable, Saudi Arabia tried to return to its traditional oil policy based on its long-term economic interests (see Figure 3).

In a slack market, the efforts of Saudi policy makers to achieve moderate oil prices have been a little different. When long-term economic interests are primarily considered in an oil slump, the Saudis have usually tried to achieve moderate oil prices by cutting production. One important thing here is the different meaning of the notion of moderate oil prices in a slack market condition. At this point, the Saudis find it difficult to lower official oil prices in spite of their relatively high levels, because this will trigger price competitions among oil producing countries and may result in a disastrous price collapse, which would allow market forces to take over the world oil market. Therefore, the point of aiming for moderate oil prices in a slack market is to prevent a price collapse and Saudi Arabia has regarded itself as obliged to defend OPEC's pricing system even at relatively high levels. In the process of achieving a desirable price, Saudi policy makers need to acquire price and production discipline within OPEC, as well as cooperation from non-OPEC suppliers. This paradigm of Saudi oil policy is visible in the first half of the 1980s. However, without securing these two objectives in seeking the stabilization of the world oil prices, cuts in Saudi production will become economically unacceptable. In a slack market, it is not pressure from outside the country, but growing internal discontent that obliges Saudi policy makers to increase oil production to restore their market share, as happened in the middle of 1985. However, this politically motivated decision would very likely bring about a price collapse and huge adverse price repercussions in the world

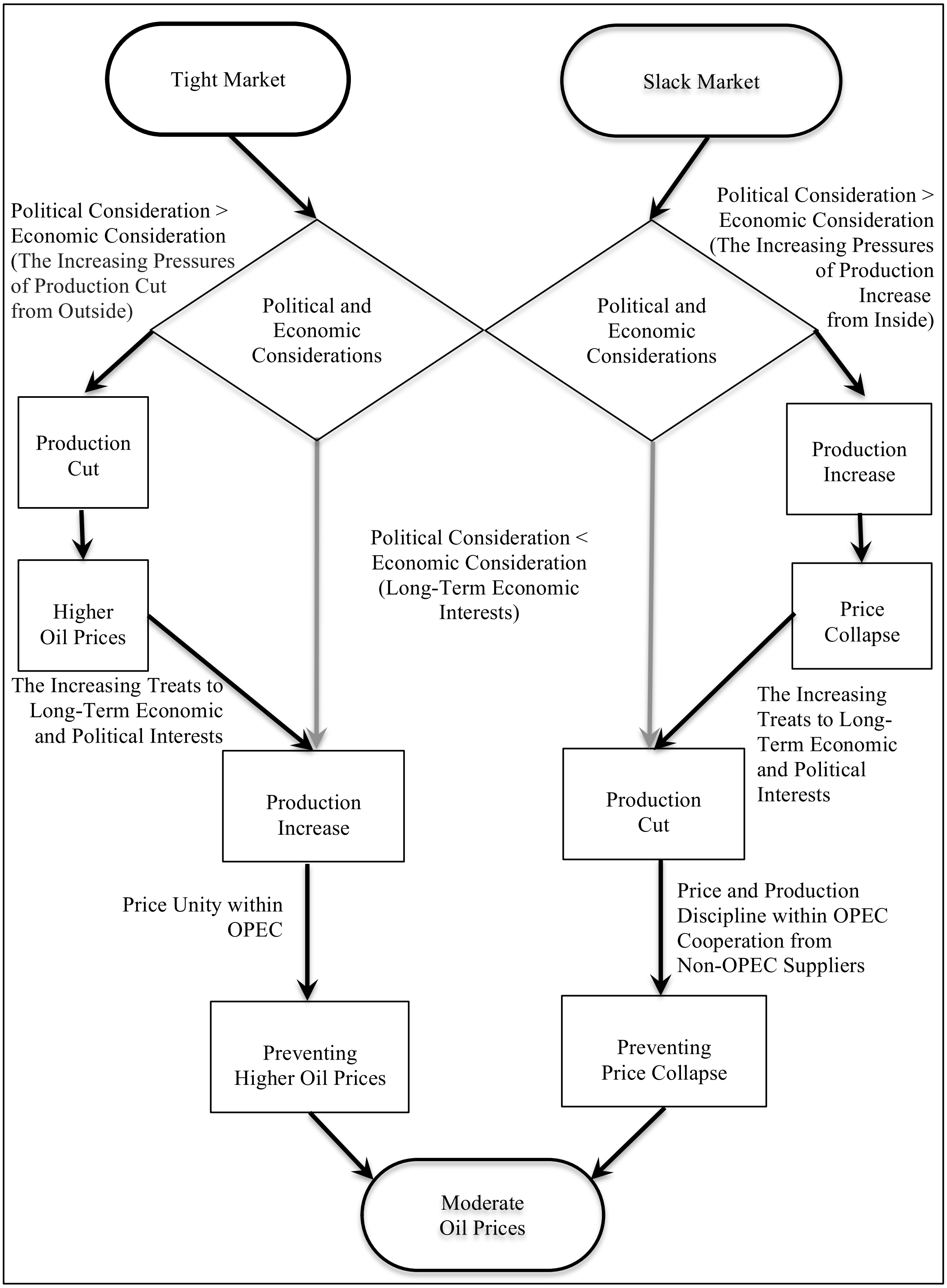

Figure 3. The Patterns of Saudi Oil Policy in Different Market Conditions.

oil market; all of which threatens Saudi Arabia's long-term economic and political interests. Therefore, policy makers try to implement a policy based on the country's long-term economic interests as soon as they judge that other oil producing countries are ready to cooperate by making voluntary cuts in their production to prevent a further collapse in the price. This largely explains Saudi oil policy from the second half of 1986 to June 1987 (see Figure 3).

However, after the failure of all the efforts of Saudi policy-makers to achieve desirable oil prices without losing a major part of their market share, they abandoned the country's role as a price setter in June 1987, and adopted a market-related oil-pricing system based on formula pricing. Given the absence of monitoring mechanisms within OPEC to regulate production and prices, and also of any cooperation from the non-OPEC suppliers, Saudi Arabia should have realized that its efforts to set oil prices would be in vain as well as involving huge costs. However, because of the political and economic importance of oil as a strategic natural resource, Saudi Arabia could not allow profit-seeking market forces to take over price decisions without restriction. Although Saudi Arabia surrendered its price-making role in the world oil market to the logic of the free market, it did not completely give up its attempts to control oil prices. Mainly through adjusting production quotas within OPEC, it has tried to stabilize oil prices at levels it considers desirable. After its hard experiences as a price setter in the late 1970s and most of the 1980s, Saudi Arabia's policy of maximizing the long-term value of its oil has changed to reacting to market-oriented oil prices rather than actively determining oil prices. It has occasionally played a somewhat limited swing producer role to secure its long-term economic and political interests. For example, the Gulf Crisis of 1990-91 removed approximately 4 million b/d of the oil production of Iraq and Kuwait. At that time, Saudi Arabia immediately increased its production to avert a disastrous shortfall on the world oil market. There were similar reactions in the late 1990s as well as in 2003, when the United States invaded Iraq.[4] However, since the mid-1980s, it has not assumed an active swing producer role by making unnecessarily large cuts in production to protect oil prices.

We may be able to anticipate future Saudi oil policy from the previous behavior of Saudi oil decision-makers. There is a high probability that it will increase its production to stabilize prices in a tight market. This decision will not only satisfy Saudi Arabia's long-term economic and political interests, but also bring substantial profits in the short-term. As we have witnessed, there have been no serious political threats from neighboring oil-producing countries to the Saudi regime to reduce its oil production since the 1990s, and Saudi Arabia has continuously played a swing producer role by increasing its output to prevent oil supply shortages in a tight market. Furthermore, the political situation in the Middle East in 2014, with the fall or weakening of radical Arab regimes such as Iraq and Syria, will allow Saudi Arabia to take the role of swing producer in a tight market without any serious political interference. Even then, it is unlikely that the Arab oil producing countries will use their oil as a political weapon as in the 1973-74 Arab oil embargo in the current political context. Although highly unlikely, if Saudi Arabia were to join in any politically motivated oil embargo, the impact of such an embargo on the world oil market will not be as great as the situation in 1973-74 because of the current structure of the world oil market, in which OPEC production only

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[4] Abdullah Ibrahim Elmoneif, "The Kingdom of Saudi Arabia in World Politics: Oil, Islam and International Peace" (PhD diss., Howard University, 2005), 143.

accounted for 42.1% of total world production in 2013.[5] However, in a slack market, Saudi Arabia will not play any active swing producer role as it did in the early 1980s. It is likely that it would compromise with other OPEC members by agreeing to cut production to reasonable levels through the organization's quota system. Because of high population growth in Saudi Arabia and its consequently increased financial needs, it can no longer sacrifice its reasonable market share as it did in the first half of the 1980s. Such a decision, based on long-term economic and political interests, in the face of a weak oil market, would seriously undermine the stability of the Saudi regime. Internal rather than external factors will be the main influences on Saudi oil policy in the future.

Saudi oil policy in the first half of the 1980s as a swing producer was clearly based on Yamani's vision of the world oil market. His negative views of market forces and his strong belief that Saudi Arabia could secure its long-term economic and political interests by implementing a long-term strategy for OPEC led him to push through this economically painful policy. Even after his dismissal in October 1986, he still had similar opinions on market forces. In a speech delivered to members of the Institute of Petroleum on March 8, 1990, he concluded: "oil price stability is necessarily an elusive goal under free-market conditions . . . It is time we explored the possibility of setting up a general framework of mutual cooperation between the parties concerned, in order to avoid a damaging price spike in the not too distant future." [6] However, his anticipation of the future of the oil market in the 1990s did not involve any overt cooperation between the

[5] British Petroleum, "BP Statistical Review of World Energy June 2014," (British Petroleum, 2014), 8.

[6] Ahmad Zaki Yamani, "The necessity for Cooperation in the Oil Industry," *Middle East Economic Survey* XXXIII, no. 26 (April 2, 1990): D2.

parties concerned. Even given that market forces determine oil prices, and that the OPEC quota system has a limited influence on prices, the world oil market has experienced relatively stable oil prices without the major fluctuations of the 1970s and the 1980s. It seems unlikely that Yamani still believes that market forces play a vicious role in the world oil market, or that his oil policy of making Saudi Arabia a swing producer during the first half of the 1980s was worth the cost to the domestic economy in the short- and midterm for a vision of a world oil market that now seems completely unrealistic.

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